

Fiscal Policy

The government can influence the level of aggregate consumption by changing its spending, borrowing, and taxation policies:

Assume ceteris paribus conditions (i.e. Everything but the variable in question remains constant).

- The government influences consumption by changing the disposable incomes of consumers (i.e. disposable income = income that remains after taxes). In general, disposable income $\uparrow \Rightarrow$ consumption \uparrow and disposable income $\downarrow \Rightarrow$ consumption \downarrow . Recall from the Production - Consumption Model that consumption $>$ production \Rightarrow prices may \uparrow and consumption $<$ production \Rightarrow prices may \downarrow .
- Taxes $\uparrow \Rightarrow$ disposable income $\downarrow \Rightarrow$ consumption $\downarrow \Rightarrow$ inventories $\uparrow \Rightarrow$ prices may \downarrow .
- Taxes $\downarrow \Rightarrow$ disposable income $\uparrow \Rightarrow$ consumption $\uparrow \Rightarrow$ inventories $\downarrow \Rightarrow$ prices may \uparrow .
- Government spending $\uparrow \Rightarrow$ disposable income $\uparrow \Rightarrow$ consumption $\uparrow \Rightarrow$ inventories $\downarrow \Rightarrow$ prices may \uparrow .
- Government spending $\downarrow \Rightarrow$ disposable income $\downarrow \Rightarrow$ consumption $\downarrow \Rightarrow$ inventories $\uparrow \Rightarrow$ prices may \downarrow .

Select the correct answer or provide an answer:

1. The tax rate drops from 15% to 10%. What happens?
 - a) disposable income $\uparrow \Rightarrow$ consumption $\uparrow \Rightarrow$ inventories $\uparrow \Rightarrow$ prices \uparrow .
 - b) disposable income $\uparrow \Rightarrow$ consumption $\uparrow \Rightarrow$ inventories $\downarrow \Rightarrow$ prices \uparrow .
 - c) disposable income $\uparrow \Rightarrow$ consumption $\uparrow \Rightarrow$ inventories $\downarrow \Rightarrow$ prices \downarrow .
 - d) disposable income $\downarrow \Rightarrow$ consumption $\uparrow \Rightarrow$ inventories $\downarrow \Rightarrow$ prices \downarrow .
 - e) disposable income $\downarrow \Rightarrow$ consumption $\downarrow \Rightarrow$ inventories $\uparrow \Rightarrow$ prices \uparrow .
 - f) disposable income $\downarrow \Rightarrow$ consumption $\downarrow \Rightarrow$ inventories $\uparrow \Rightarrow$ prices \downarrow .

2. The tax rate rises from 20% to 25%. What happens?

- a) disposable income \uparrow \Rightarrow consumption \uparrow \Rightarrow inventories \uparrow \Rightarrow prices \uparrow .
- b) disposable income \uparrow \Rightarrow consumption \uparrow \Rightarrow inventories \downarrow \Rightarrow prices \uparrow .
- c) disposable income \uparrow \Rightarrow consumption \uparrow \Rightarrow inventories \downarrow \Rightarrow prices \downarrow .
- d) disposable income \downarrow \Rightarrow consumption \uparrow \Rightarrow inventories \downarrow \Rightarrow prices \downarrow .
- e) disposable income \downarrow \Rightarrow consumption \downarrow \Rightarrow inventories \uparrow \Rightarrow prices \uparrow .
- f) disposable income \downarrow \Rightarrow consumption \downarrow \Rightarrow inventories \uparrow \Rightarrow prices \downarrow .

3. Government spending increases. What happens?

- a) disposable income \uparrow \Rightarrow consumption \uparrow \Rightarrow inventories \uparrow \Rightarrow prices \uparrow .
- b) disposable income \uparrow \Rightarrow consumption \uparrow \Rightarrow inventories \downarrow \Rightarrow prices \uparrow .
- c) disposable income \uparrow \Rightarrow consumption \uparrow \Rightarrow inventories \downarrow \Rightarrow prices \downarrow .
- d) disposable income \downarrow \Rightarrow consumption \uparrow \Rightarrow inventories \downarrow \Rightarrow prices \downarrow .
- e) disposable income \downarrow \Rightarrow consumption \downarrow \Rightarrow inventories \uparrow \Rightarrow prices \uparrow .
- f) disposable income \downarrow \Rightarrow consumption \downarrow \Rightarrow inventories \uparrow \Rightarrow prices \downarrow .

4. Government spending decreases. What happens?

- a) disposable income \uparrow \Rightarrow consumption \uparrow \Rightarrow inventories \uparrow \Rightarrow prices \uparrow .
- b) disposable income \uparrow \Rightarrow consumption \uparrow \Rightarrow inventories \downarrow \Rightarrow prices \uparrow .
- c) disposable income \uparrow \Rightarrow consumption \uparrow \Rightarrow inventories \downarrow \Rightarrow prices \downarrow .
- d) disposable income \downarrow \Rightarrow consumption \uparrow \Rightarrow inventories \downarrow \Rightarrow prices \downarrow .
- e) disposable income \downarrow \Rightarrow consumption \downarrow \Rightarrow inventories \uparrow \Rightarrow prices \uparrow .
- f) disposable income \downarrow \Rightarrow consumption \downarrow \Rightarrow inventories \uparrow \Rightarrow prices \downarrow .

5. Government spending and taxes both increase. What happens?

- a) disposable income \uparrow \Rightarrow consumption \uparrow \Rightarrow inventories \uparrow \Rightarrow prices \uparrow .
- b) disposable income \uparrow \Rightarrow consumption \uparrow \Rightarrow inventories \downarrow \Rightarrow prices \uparrow .
- c) disposable income \uparrow \Rightarrow consumption \uparrow \Rightarrow inventories \downarrow \Rightarrow prices \downarrow .
- d) disposable income \downarrow \Rightarrow consumption \downarrow \Rightarrow inventories \uparrow \Rightarrow prices \downarrow .
- e) answer is ambiguous.

6. Income is \$10,000 and the tax rate is 10%. What is the level of disposable income?

- a) \$1,000
- b) \$5,000
- c) \$9,000
- d) \$10,000

7. Income increases from \$30,000 to \$32,000. The tax rate increases from 15% to 25%. What happens?

- a) disposable income \uparrow \Rightarrow consumption \uparrow \Rightarrow inventories \uparrow \Rightarrow prices \uparrow .
- b) disposable income \uparrow \Rightarrow consumption \uparrow \Rightarrow inventories \downarrow \Rightarrow prices \uparrow .
- c) disposable income \uparrow \Rightarrow consumption \uparrow \Rightarrow inventories \downarrow \Rightarrow prices \downarrow .
- d) disposable income \downarrow \Rightarrow consumption \uparrow \Rightarrow inventories \downarrow \Rightarrow prices \downarrow .

e) disposable income $\downarrow \Rightarrow$ consumption $\downarrow \Rightarrow$ inventories $\uparrow \Rightarrow$ prices \downarrow .

8. Income decreases from \$21,000 to \$20,000. The tax rate decreases from 15% to 10%. What happens?

a) disposable income $\uparrow \Rightarrow$ consumption $\uparrow \Rightarrow$ inventories $\uparrow \Rightarrow$ prices \uparrow .

b) disposable income $\uparrow \Rightarrow$ consumption $\uparrow \Rightarrow$ inventories $\downarrow \Rightarrow$ prices \uparrow .

c) disposable income $\uparrow \Rightarrow$ consumption $\uparrow \Rightarrow$ inventories $\downarrow \Rightarrow$ prices \downarrow .

d) disposable income $\downarrow \Rightarrow$ consumption $\uparrow \Rightarrow$ inventories $\downarrow \Rightarrow$ prices \downarrow .

e) disposable income $\downarrow \Rightarrow$ consumption $\downarrow \Rightarrow$ inventories $\uparrow \Rightarrow$ prices \uparrow .

f) disposable income $\downarrow \Rightarrow$ consumption $\downarrow \Rightarrow$ inventories $\uparrow \Rightarrow$ prices \downarrow .

Monetary Policy

The Federal Reserve can influence the level of consumption by changing the money supply:

The Federal Reserve influences consumption by changing the nominal interest rate (i.e. nominal interest rate = real interest rate + inflation rate + risk premium). Recall that the three ways to change the money supply are open market operations (i.e. buying and selling of government securities), changes in the discount rate (i.e. rate at which banks can borrow from the Federal Reserve), and changes in the reserve requirements (i.e. percentage of deposits that banks must hold and not loan).

Assume ceteris paribus conditions (i.e. Everything but the variable in question remains constant).

- Money supply $\uparrow \Rightarrow$ interest rates \downarrow due to there being more money available for loans \Rightarrow discretionary income \uparrow due to the cost of borrowing decreasing (i.e. discretionary income = disposable income - basic housing bills, basic utility bills, basic food bills, etc.) \Rightarrow consumption \uparrow due to some of the increase in discretionary income being spent on consumption $\Rightarrow P \uparrow$ if consumption $>$ production (refer to the Production - Consumption Model). Note: If unemployment is high, it may be possible to increase production in the short run by hiring additional labor. This means that it may not be necessary to increase prices to eliminate declining inventories. If unemployment is low, it probably will not be possible to increase production in the short run by hiring additional labor. In this case, it is probably necessary to increase prices to eliminate declining inventories.

- When the money supply initially increases, interest rates fall due to there being more money available for loans. In the long run, an increase in the money supply will raise prices, as demonstrated above. Recalling that the nominal interest rate = real interest rate + inflation rate + risk premium, an increase in prices (i.e. inflation) will

raise the nominal interest rate. The economy will then behave as if the money supply decreases (see the next page).

- Money supply $\downarrow \Rightarrow$ interest rates \uparrow due to there being less money available for loans \Rightarrow discretionary income \downarrow due to the cost of borrowing increasing (i.e. discretionary income = disposable income - basic housing bills, basic utility bills, basic food bills, etc.) \Rightarrow consumption \downarrow due to having less money to spend on consumption $\Rightarrow P \downarrow$ if consumption $<$ production (refer to the Production - Consumption Model).

Select the correct answer or provide an answer:

1. The money supply increases. What happens?

- a) interest rates $\downarrow \Rightarrow$ discretionary income $\uparrow \Rightarrow$ consumption $\downarrow \Rightarrow$ prices may $\uparrow \Rightarrow$ interest rates may \uparrow .
- b) interest rates $\downarrow \Rightarrow$ discretionary income $\downarrow \Rightarrow$ consumption $\downarrow \Rightarrow$ prices may $\uparrow \Rightarrow$ interest rates may \uparrow .
- c) interest rates $\downarrow \Rightarrow$ discretionary income $\uparrow \Rightarrow$ consumption $\uparrow \Rightarrow$ prices may $\uparrow \Rightarrow$ interest rates may \uparrow .
- d) interest rates $\uparrow \Rightarrow$ discretionary income $\downarrow \Rightarrow$ consumption $\downarrow \Rightarrow$ prices may $\downarrow \Rightarrow$ interest rates may \downarrow .
- e) interest rates $\uparrow \Rightarrow$ discretionary income $\downarrow \Rightarrow$ consumption $\uparrow \Rightarrow$ prices may $\downarrow \Rightarrow$ interest rates may \downarrow .

2. Money supply decreases. What happens?

- a) interest rates $\downarrow \Rightarrow$ discretionary income $\uparrow \Rightarrow$ consumption $\downarrow \Rightarrow$ prices may $\uparrow \Rightarrow$ interest rates may \uparrow .
- b) interest rates $\downarrow \Rightarrow$ discretionary income $\downarrow \Rightarrow$ consumption $\downarrow \Rightarrow$ prices may $\uparrow \Rightarrow$ interest rates may \uparrow .
- c) interest rates $\downarrow \Rightarrow$ discretionary income $\uparrow \Rightarrow$ consumption $\uparrow \Rightarrow$ prices may $\uparrow \Rightarrow$ interest rates may \uparrow .
- d) interest rates $\uparrow \Rightarrow$ discretionary income $\downarrow \Rightarrow$ consumption $\downarrow \Rightarrow$ prices may $\downarrow \Rightarrow$ interest rates may \downarrow .
- e) interest rates $\uparrow \Rightarrow$ discretionary income $\downarrow \Rightarrow$ consumption $\uparrow \Rightarrow$ prices may $\downarrow \Rightarrow$ interest rates may \downarrow .

3. Income is \$40,000 and the tax rate is 15%. \$28,000 is spent on basic necessities. What is the level of discretionary income?

- a) \$4,000
- b) \$6,000
- c) \$12,000
- d) \$28,000

4. Money supply increases and government spending decreases. What happens?

- a) consumption $\uparrow \Rightarrow$ prices may \uparrow .

- b) consumption $\downarrow \Rightarrow$ prices may \downarrow .
- c) consumption $\downarrow \Rightarrow$ prices may \uparrow .
- d) ambiguous