

A Macroeconomics Study Question (Answers on subsequent pages)

Congress and the President may soon pass legislation that cuts FICA taxes, increases government purchases of goods and services, and extends unemployment benefits. Now forecast how this legislation, if implemented, will affect various measures of economic performance.

Will each variable below tend to *increase*, *decrease*, or be *unaffected* in the short run by the implementation of the legislation? Carefully explain the cause of each change in each variable.

- a) GDP
- b) Unemployment
- c) Gross private domestic investment
- d) The Federal budget surplus
- e) The U.S. trade deficit
- f) inflation

If the tax cut and spending hikes are permanent, then:

- g) how are long term growth prospects, future standards of living, and the U.S. external debt affected in the very long term?

a) GDP rises because spending (aggregate demand) rises. Two components of aggregate demand rise:

--personal consumption expenditures rise, since consumers have more income to spend as a result of the tax cuts and increase in unemployment benefits

--government purchases rise, since the government is directly buying more stuff
Producers respond to higher spending by increasing their production to meet the desired higher level of spending. Higher production is higher gross domestic product.

b) Unemployment tends to fall, since the higher level of production usually means that firms need more workers, so they hire more people, removing some from the ranks of the unemployed.

c) Investment falls because of higher interest rates. Interest rates rise because the government is contributing less to the nation's pool of savings, since the government's tax cuts and spending hikes reduce its surplus. A smaller pool of savings means that borrowers (including those who want to invest) must pay a higher interest rate, discouraging investment.

d) The budget surplus shrinks. The budget surplus is defined as the excess of tax and fee revenue above government spending. This legislation will result in reduced tax revenue and higher government spending, so that surplus shrinks. It could even disappear, leaving the Federal government with a budget deficit.

e) The trade deficit rises because the dollar appreciates relative to foreign currency. The dollar appreciates due to higher U.S. interest rates.

f) Inflation rises because higher spending in the economy (as described in (a) above) tends to increase the prices that firms charge. (Since inflation is currently low, this is not a big problem now, though it may be a problem next year.)

g) Since a big chunk of investment involves replacement and augmentation of the economy's stock of physical capital, the drop in investment reduces the long term size of the capital stock. This reduces the long term potential GDP of the US, probably causing future generations to have lower material living standards than they would otherwise have. In addition, a higher trade deficit increases the debt that the U.S. owes to foreigners, and paying the interest on this debt will also be a burden to future generations.