

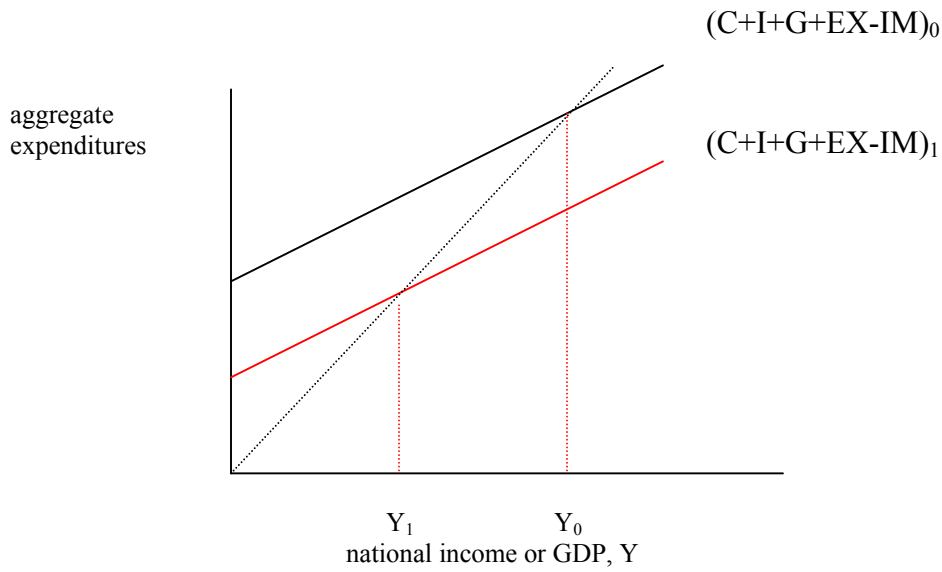
Cooleconomics.com
Principles of Economics

Another Model 2 Study Question

The Fruitlands economy is currently in equilibrium, but President Dinah Mite wants to be prepared for any contingency. She asks you, Jim Nasium, her economic advisor, what will happen to the economy if any of the following events were to (separately) occur:

- a) Households become pessimistic.
 - b) The government cuts Medicare spending.
 - c) The government cuts household tax rates.
 - d) Firm managers become optimistic.
- i) On 4 separate graphs (one each for a-d), illustrate what would happen to equilibrium GDP if events (a)-(d) were to (separately) occur, using model #2 of an economy.
- ii) In 8 separate responses (2 each for a-d), indicate what happens to the budget deficit and consumption if (a)-(d) were to (separately) occur, and explain why they change.

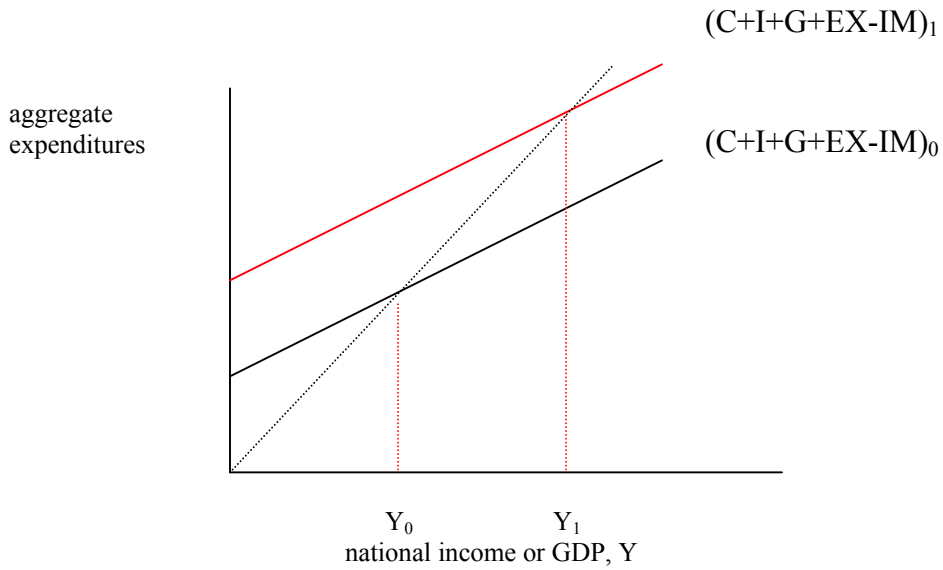
i) Pessimistic households reduces Consumption, causing the AE curve to shift downward:



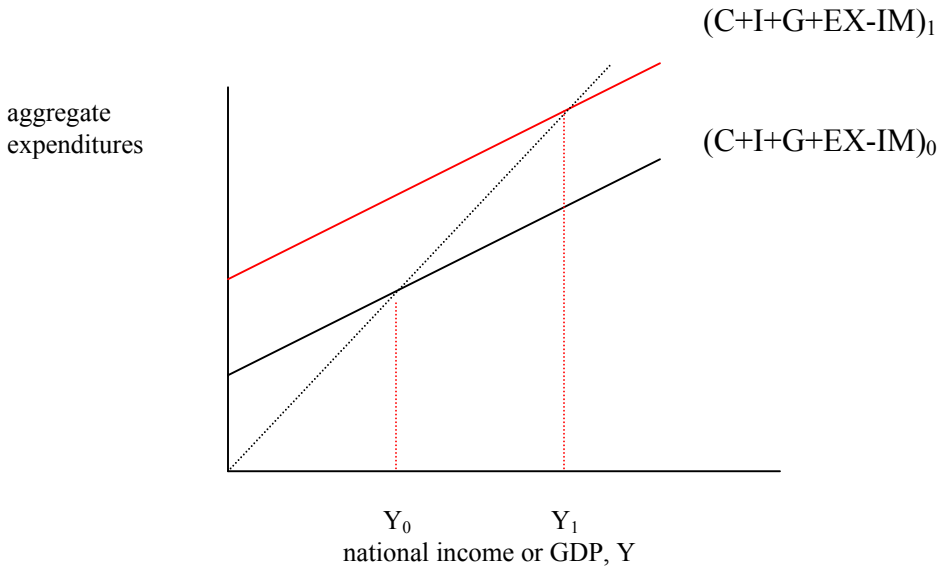
Medicare spending reduction is a reduction of a transfer payment, reducing disposable income, reducing C, causing the AE curve to shift down:



Lower tax rates increases disposable income, increases consumption, causes AE to shift up:



Optimistic firm managers increase investment, shifting AE up:



ii)

Pessimistic households:

--Reduce consumption because they save more money, worried about their future finances.

--Since Y falls, the tax base has shrunk, reducing tax revenue. Lower tax revenue in combination with constant government spending means that the government will have to borrow more money—a higher budget deficit. (If the government originally had a budget surplus then the surplus will shrink or disappear and become a deficit)

Less Medicare spending

--Reduces consumption since this is a transfer payment, giving households less income to spend and save

--Lower government spending without lower tax rates means less government borrowing is needed to pay for the spending—a lower budget deficit (or the deficit could disappear completely and become a surplus). (If the government originally had a budget surplus then the surplus will increase)

Lower tax rates

--Increases consumption since this increases disposable income

--Lower tax rates result in lower tax revenue. If government spending is maintained then government must borrow more—a higher budget deficit. (If the government originally had a budget surplus then the surplus will shrink or disappear and become a deficit)

Optimistic firms

--Since Y has risen, households have more income. This results in higher consumption (the investment multiplier effect).

--Since Y rises, the tax base has grown, increasing tax revenue. Higher tax revenue in combination with constant government spending means that the government will have to borrow less money—a lower budget deficit. Indeed, the deficit may disappear completely and become a surplus. (If the government originally had a budget surplus then the surplus will increase.)