# Fiscal Policy and the Multiplier

Use your knowledge of multipliers and fiscal policy to answer each of the following questions.

1. Real GDP is currently $600 billion above potential GDP and price inflation is beginning to dominate the headlines. Draw a correctly labeled AD/AS graph to show the problem in the economy. How could the government adjust taxes or transfers to return the economy to full employment? Assume the MPC=.75. How large would this lump-sum adjustment need to be? Show the impact of the policy on output and price level on the graph you drew previously.
2. Current real GDP is $6 trillion and potential GDP is $7.5 trillion. Draw a correctly labeled AD/AS graph to show the problem in the economy. The government is prepared to pass a spending package to return the economy to full employment. What kind of spending package should be passed and how big does it need to be? Assume that the MPC = .90. Show the impact of the policy on output and price level on the graph you drew previously.

# Fiscal Policy and the Multiplier Answer Key

Use your knowledge of multipliers and fiscal policy to answer each of the following questions.

1. Real GDP is currently $600 billion above potential GDP and price inflation is beginning to dominate the headlines. Draw a correctly labeled AD/AS graph to show the problem in the economy. How could the government adjust taxes or transfers to return the economy to full employment? Assume the MPC=.75. How large would this lump-sum adjustment need to be? Show the impact of the policy on output and price level on the graph you drew previously.

*Answer: Because the economy is suffering from inflation, taxes need to be raised or transfers need to*

*be cut. The tax multiplier Tm =* .75

(1−.75)

*= 3. To*

*reduce real GDP by $600 billion, taxes need to be increased (or transfers need to be decreased) by*

$600 𝑏𝑖𝑙𝑙𝑖𝑜𝑛 *= $200 billion.*

3

1. Current real GDP is $6 trillion and potential GDP is $7.5 trillion. Draw a correctly labeled AD/AS graph to show the problem in the economy. The government is prepared to pass a spending package to return the economy to full employment. What kind of spending package should be passed and how big does it need to be? Assume that the MPC = .90. Show the impact of the policy on output and price level on the graph you drew previously.

*Answer: The economy is in a recession so spending must be increased with expansionary fiscal policy. The*

*spending multiplier M =* 1

(1−.90)

*= 10. To increase real*

*GDP by $1.5 trillion, government spending needs to be*

*increased by* $1.5 𝑡𝑟𝑖𝑙𝑙𝑖𝑜𝑛 *= $.15 trillion or $150 billion.*

10