1. John Keynes suggested that government should… (finish the sentence)

2. The three tools of Fiscal policy are… (list 3 below)
   a. 
   b. 
   c. 

3. Expansionary Fiscal Policy will increase ____________ and _______________. As a result this policy will lower ________________. (fill in blanks)

4. When the economy is in a recession the government will use Fiscal policy to close a ________________ gap. (fill in blanks)

5. When the economy is experiencing inflation the government will use Fiscal policy to close a ________________ gap. (fill in blanks)

6. List four of the PROBLEMS with Fiscal Policy: (list below: PUT IT IN YOUR OWN WORDS!!!)
   a. 
   b. 
   c. 
   d. 

7. Because of the ________________ ________________ the government may accidentally cause a recession or inflation because of too little or too much money in the economy. (2 word answer; fill in the blanks)

8. Explain how increasing taxes and increasing transfer payments can affect (a) the labor supply and (b) producers. (TWO PART ANSWER. Explain below)

9. When prices continue to rise as the nation goes into a recession, this event is called _________________. (fill in blank)
10. In as few words as possible, precisely describe how **progressive income tax** helps to regulate the business cycle? *(Explain below)*

11. A tax that is more burdensome on the poor because the poor pay a larger proportion of their income in tax is called a ______________________________. *(2 word answer; fill in blanks)*

12. Someone who argues that Highway 575 should be repaved with money received from a toll plaza placed in Woodstock and another in Canton would most likely agree with the ______________________________ principle. *(BENEFITS-RECEIVED or ABILITY TO PAY; fill in blank)*

13. The **THREE** tools of Monetary Policy are … *(list 3 below)*
   a. 
   b. 
   c. 

14. List **FOUR** of the functions of the Federal Reserve Bank: *(list 4 below)*
   a. 
   b. 
   c. 
   d. 

15. There are ________ regions within the Federal Reserve System. *(fill in blank)*

16. In order to bring about growth, the Fed will ___________ bonds. *(BUY or SELL; fill in blank)*

17. In order to slow down the economy, the Fed will ___________ bonds. *(BUY or SELL; fill in blank)*

18. The amount of money from which a bank can give out loans is referred to as its ______________ ________________. It is a number based on a federally mandated ratio. *(2 word answer; fill in all blanks)*

19. The Fed can slow down the economy by ______________ the reserve ratio/requirement. *(DECREASE or INCREASE; fill in blank)*
20. The Fed can cause growth in the economy by _________________ the discount rate. *(DECREASE or INCREASE; fill in blank)*

21. **THREE** functions of money are… *(list 3 below)*
   a.  
   b.  
   c.  

22. I put $500 of my money in a bank account. In about two months from now I will withdraw the money and use it on a new stereo. In this case, money is serving as which of the three functions? *(answer below)*

23. Fiat money is different from commodity money because fiat money has no _________________ value. *(fill in blank)*
UNIT 12: FIXING AN ECONOMY: FISCAL POLICY NOTES

1.) Definition & Major Points
Fiscal policy refers to government purchases, transfer payments, taxes, and borrowing as they affect macroeconomic variables such as real GDP, employment, the price level, and economic growth.

1. Using the demand-side economics, we will initially focus on the demand to consider the effect of changes in government purchases, transfer payments, and taxes on real GDP.
2. The short story is that at any given price level, an increase in government purchases or in transfer payments increases real GDP, and an increase in taxes decreases real GDP.
3. Fiscal policy began after the Great Depression when classical economists realized that **laissez faire economics** (no government regulation) would not help deal with the Great Depression.
4. John Keynes suggested that the **GOVERNMENT** should use **FISCAL POLICY** to control **demand** as a means of controlling the economy during the business cycle.

- **FISCAL POLICY** uses the following **THREE TOOLS**:
  - **TAXES**
  - **ENTITLEMENT SPENDING**
  - **GOVERNMENT SPENDING** (other than entitlement spending items)

2.) Closing a Contractionary Gap
(Controlling a Recession)

When the economy is in a contraction or recession, the government will enact an **EXPANSIONARY FISCAL POLICY** to "expand" the economy. There by increasing GDP, disposable income and lowering unemployment. A result of this policy is an increase in the price level.

They will push the aggregate demand curve to the right by doing the following:

1. **Decreasing Taxes** (more money in people's pockets)
2. **Increasing Transfer Payments** (more money in people's pockets)
3. **Increase Government Spending on social programs & military** (more money in people's pockets)
3.) **Closing a Expansionary Gap** (Controlling Inflation)
When the economy is in an expansion which results in high prices, the government will enact a **CONTRACTIONARY FISCAL POLICY** to "contract" the economy. There by decreasing GDP and increasing unemployment. A result of this policy is a decrease in the price level.

REMEMBER THAT FISCAL POLICY IS A TOOL TO HELP STABILIZE PRICES AND CONTROL UNEMPLOYMENT.

Since unemployment is linked to GDP, it is possible that when the government enacts a Contractionary Policy to decrease aggregate demand, that unemployment is going to increase. However, mild unemployment is BETTER than hyperinflation.

They will push the aggregate demand curve to the right by:
1. **Increasing taxes** (less money in people's pockets)
2. **Decreasing transfer payments** (less money in people's pockets)
3. **Decrease government spending** (less money in people's pockets)

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4.) **Problems with Fiscal Policy**
Other concerns also caused economists and policy makers to question the effectiveness of discretionary fiscal policy

1. The difficulty of estimating the natural rate of unemployment (REMEMBER IN ORDER TO KNOW WHERE POTENTIAL OUTPUT IS, ONE NEEDS TO KNOW THE RATE OF EMPLOYMENT).
2. The time required approving and implementing fiscal legislation may hamper its effectiveness and weaken discretionary fiscal policy and may in fact do more harm than good
3. The distinction between current and permanent income
4. Possible feedback effects of fiscal policy on aggregate supply

Precise **Expansionary** and **Contractionary Fiscal Policies** are difficult to achieve, for their proper execution assumes that:
- The relevant **multiplier effect** can be predicted accurately *(How much will a given amount of stimulus money affect our nation's GDP?)*

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5.) **Multiplier Effect** *(SNOWBALL EFFECT)*
- Aggregate demand can be shifted by just the right amount
- The potential level of output is accurately gauged
- Various government entities can somehow coordinate their fiscal efforts
- The shape of the short-run aggregate supply curve is known and remains constant

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6.) How can Fiscal Policy unintentionally affect Supply of Labor?

- If the government increases transfer payments (unemployment compensation) too much during a **contractionary period (recession)**: During Expansionary policy, the unemployed, who benefit from increased transfer payments, now have less incentive to find work.
- If the government decreases taxes too much during a **expansionary period (economic boom)**: During Contractionary policy, workers who find their wage reduced by the higher tax rates may be less willing to work.
- Both of these situations would reduce the aggregate supply curve, which would cause high prices (high inflation) and lowers GDP. (Graph it and you will see why this would be true)

7.) What if the government stimulates the economy TOO much?

1. If the government does not estimate potential output or the natural rate of unemployment correctly, then they may stimulate the economy too much.
2. This will cause the aggregate demand to go past potential output and cause increased GDP, but increased prices.
3. If they do not correct this, then suppliers will not be able to maintain production with increased price and aggregate supply will decline causing high higher prices and decreased GDP (high unemployment). This is called **stagflation**.

8.) **Automatic Stabilizers:**

Automatic stabilizers are meant to smooth fluctuations in disposable income over the business cycle. They refer to revenue and spending items in the federal budget that automatically change with the ups and downs of the economy so as to stabilize disposable income and, hence, consumption and real GDP

Two good examples of automatic stabilizers are:

1. **Progressive Income Tax**
   - The progressive income tax relieves some of the expansionary pressures that might otherwise arise when output increases above its potential during an economic expansion
   - Conversely, when the economy is in a recession, real GDP declines but taxes decline faster, so disposable income does not fall as much as real GDP (stabilizes the contraction so that aggregate demand does not decline too much)

2. **Unemployment Compensation**
   - During an economic expansion, more money from unemployment insurance taxes flow into the insurance fund, thereby stabilizing aggregate demand (taking money out of the economy)
   - During a recession, unemployment payments automatically flow from the insurance fund to those who have become unemployed. Thus, increasing disposable income and consumption, thereby stabilizing aggregate demand (putting money into the economy)
9.) **Types of Taxation** Who should pay the taxes? The age-old debate...

- **Benefits-Received Principle:** Only those who receive benefits should pay taxes
- **Ability-to-Pay Principle:** Only those with the ability to pay should pay MORE of the tax

1. **Progressive Tax:** Those who make more, pay more (EXAMPLE: personal income tax)
2. **Regressive Tax:** A regressive tax is a tax which takes a larger percentage of income from people whose income is low. It places proportionately more of a burden on those with lower incomes.
   - Regressive taxes, as opposed to progressive taxes, are more burdensome on lower-income individuals than on higher-income individuals.
   - EXAMPLE: sales tax & property taxes
3. **Proportional Tax:** A tax that charges the same percentage of income, regardless of the size of income
   - Basically, whether a tax is REGRESSIVE or a FLAT tax DEPENDS on if you are rich or poor. The poor person will look at a 6% sales tax and say that is unfair and puts more burdensome on them.
   - However, a rich person will say that the 6% sales tax is fair and that everyone pays the same percent at the register.
   - Though this may be true, the poor person needed that money more than the rich.
UNIT 13: FIXING AN ECONOMY: MONETARY POLICY & FEDERAL RESERVE NOTES

1.) Functions of the Fed
- The Federal Reserve (Fed) serves as the nation’s central bank.
- It conducts MONETARY POLICY
- It is designed to oversee the banking system.
- It regulates the quantity of money in the economy.

The Fed has three tools in its monetary toolbox:
1. Open-market operations
2. Changing the reserve requirement
3. Changing the discount rate

2.) The Structure of the Federal Reserve System
The primary elements in the Federal Reserve System are:

1. The Board of Governors
   - The Fed is run by a Board of Governors, which has seven members appointed by the President and confirmed by the Senate.
   - Among the seven members, the most important is the chairman. The chairman directs the Fed staff, presides over board meetings, and testifies about Fed policy in front of Congressional Committees.

2. The 12 Regional Federal Reserve Banks
   The Federal Reserve System is made up of the Federal Reserve Board in Washington, D.C., and twelve regional Federal Reserve Banks. The New York Fed implements some of the Fed’s most important policy decisions.

3. The Federal Open Market Committee (FOMC):
   - Serves as the main policy-making organ of the Federal Reserve System
   - Meets approximately every six weeks to review the economy.
   - All actions to regulate the economy by this committee are called OPEN-MARKET OPERATIONS.

3.) Tools of the Federal Reserve

TOOL #1: Open-Market Operations
The money supply is the quantity of money available in the economy. The primary way in which the Fed changes the money supply is through open-market operations (The Fed purchases and sells U.S. government bonds).
- To increase the money supply, the Fed buys government bonds from the public.
- To decrease the money supply, the Fed sells government bonds to the public.

Here's how it works. When the Fed wants to increase the money supply, it buys securities. The Fed purchases securities from a bank and pays for the securities by adding a credit to the bank's reserve. The bank can lend the excess money to consumers in the market. This increases the amount of money in the banking system, which speeds the economy up by increasing the amount of money banks have to loan out. This stimulates the economy by increasing business and consumer spending because banks have more money to lend. When there is MORE money in the economy, interest rates are lowered.

When the Fed wants to decrease the money supply, it sells securities. That transaction deducts an amount from the bank's reserve. This reduces the amount of money the bank has to lend in the market. This move ultimately slows the economy down by decreasing the amount of money banks have to loan out. LESS MONEY in the economy will increase interest rates and typically reduces consumer and business spending.

TOOL #2: Reserve Requirements
The money supply is affected by the amount deposited in banks and the amount that banks loan.

The fraction of total deposits that a bank has to keep as reserves is called the reserve requirement ratio. This ratio is controlled by the Federal Reserve (it is also called required reserves).

HERE IS HOW IT WORKS: The reserve requirement is the amount (%) of a bank’s total reserves that CAN NOT be loaned out. IT IS SET BY THE FEDERAL RESERVE!!
- Increasing the reserve requirement decreases the money supply.
- Decreasing the reserve requirement increases the money supply.

TOOL #3: Discount Rate
HERE IS HOW IT WORKS: The discount rate is the interest rate the Fed charges smaller banks for loans.
- Increasing the discount rate decreases the money supply. (because it is MORE expensive for banks to get the money)
- Decreasing the discount rate increases the money supply. (because it is LESS expensive for banks to get the money)
4.) **Money Supply, Interest Rates, and GDP**

1. Money supply impacts interest rates
2. Interest rates impact investment
3. Investment is a component of GDP (REMEMBER THE FORMULA: \( C + I + G + (Ex - Im) \))
4. GDP is changed as a result
   - If money supply **increases**, then interest rates **decrease**. (So GDP increases because businesses and consumers are investing MORE). This means that businesses will purchase more loans in order to advance their business. GDP WILL INCREASE AS A RESULT!
   - On the other hand, if money supply **decreases**, then interest rates **increase**. (So GDP decreases because businesses and consumers are investing LESS).
   - This means that businesses will purchase less loans in order to advance their business. GDP WILL DECREASE AS A RESULT!

5.) **Functions of Money**

WHAT MAKES MONEY, MONEY? It must have these THREE functions:

1. **Medium of Exchange** (It must be widely recognized as something with value and must be acceptable as payment for goods)
2. **Unit of Account** (It is a YARDSTICK people use to post prices and compare one good's value to another good's value)
3. **Store of Value** (It can store value to be used at sometime in the future)

6.) **Types of Money**

1. **Commodity money** takes the form of a commodity with intrinsic value. Examples: Gold, silver, cigarettes.
2. **Fiat money** is used as money because of government decree. It does **not** have intrinsic value. Examples: Present day coins, paper currency, check deposits, credit cards.