Note: Total time – 50 minutes
Answer both Part A and Part B
Part A and Part B are of equal value

USE TWO EXAM BOOKS, ONE FOR PART A AND PART B.
ON EACH EXAM BOOK PRINT YOUR NAME AND YOUR TA’S NAME.

PART A (25 minutes)

Justify, qualify, or repudiate EACH of the following statements.

(1) “The impact of the events of September 11 will cause consumers and investors to cut back sharply on their spending, thereby causing an increase in unemployment. But if the federal government tries to counter the coming slump with a sharp increase in government spending, the main effect will be an increase in American inflation.”

(2) “As a measure of the economic progress of a country, net domestic product (NDP) is preferable to gross domestic product (GDP) because the first measure includes what American factors of production earn outside of America’s borders.”

(3) “If a law were passed in America forbidding workers from changing jobs, then production possibilities in America would be reduced from many different possible bundles of goods and services to a single bundle of goods and services.

(4) “The Keynesian multiplier for changes in government spending is based on a sum to infinity. But this implies that the American economy today is still being influenced by government spending during the Roosevelt era – and that is absurd. The concept of the multiplier must therefore be absurd.”
PART B (25 minutes)

The remote island of Rushamania (with no exports and no imports) has a supreme ruler, Lord Limbaugh, who controls taxes, and a parliament which controls government spending.

Consumers always spend 50% of after-tax income, or

\[ C = 0.5(Y - T_x). \]

Investors always spend $200 billion, or

\[ I = I = 200. \]

Government spending is $150 billion, or

\[ G = 150, \]

And taxes are $100 billion, or

\[ T_x = 100. \]

FOR EACH QUESTION, SHOW ALL YOUR WORK.

1. What is the equilibrium level of national income (Y)?

2. Explain why that is an equilibrium (Be concise).

3. Investors suffer a sudden loss of confidence and cut their desired spending to $150 billion, or now

\[ I = I = 150. \]

What will be the new equilibrium level of national income (Y)?

4. Wanting to counteract the impending economic slump, Lord Limbaugh gives a tax cut of $5 billion each to his two favorite cabinet members. But these two are so wealthy they save the entire $10 billion gained through the tax cut. (Remember, the MPC of 50% is an average for the country as a whole). What will be the impact of this tax cut on the new equilibrium level of national income (your answer to (3))? Explain your answer. Again, be concise.

5. Before Lord Limbaugh can implement his tax cut, parliament learns of his plan and orders anyone who receives extra income for any reason (including a tax cut) must spend all of that extra income. Those failing to obey will be shot. If everyone obeys, and Lord Limbaugh cuts taxes by $10 billion, what will be the new level of equilibrium income?