BUSN 5260
Current Economic Analysis

Week 6: Personal Assignment
There are Internet questions with this assignment at the end.

Problems

Problem 1
The Aggregate Supply and Demand Model.

a. List three things that would cause a RIGHTWARD SHIFT in the Aggregate Demand curve.

According to Ch. 11 of the text, AD is the collective demand for all goods and services: "The total quantity of output demanded at alternative price levels in a given time period, *Ceteris Paribus*". Factors that influence AD are consumption, investment, government spending, and net exports (Shiller 9th ed. 249). An increase in any of these factors can cause a multiplier effect on the other factors, further increasing the total AD.

Some examples of things that would cause a rightward shift in the AD curve include the following: 1) Increased government spending. Schiller's example is the gov't deciding to purchase $100B on cruise missiles. Not only would this increased demand improve the revenues of the corporations that make the missiles, but they would likely higher more employees and/or increase the overall paychecks of current employees. In turn, the higher aggregate incomes would likely impact the employees comfort levels to spend more on products and services in the economy (increase in consumption), which would increase the revenues of other companies, and so on.

2) Reduction in taxes. Lower taxes on corporations would lead to an increase in the "bottom line" net revenues, which could encourage additional investment in products to expand their company capacity as well as incentivize other companies to operate in the United States vs. other countries, providing more job opportunities and a higher aggregate income, leading to increased consumption, etc. etc.

3) Reduction in interest rates and inflation. Either by market influence, or government fiscal policy, if the value of the dollar was increased (i.e. more goods and services could be purchased with the same amount of money), consumers would likely increase the total quantity of goods and services they purchased, thereby increasing the AD. Again, the multiplier effect comes in to play as revenues and incomes related to the increased purchases provide higher incomes, causing even more investment and consumption.

b. List three things that would cause a RIGHTWARD SHIFT in the Aggregate Supply curve.

The text describes AS: "The total quantity of output producers are willing and able to supply at alternative price levels in a given time period, *ceteris paribus*." To shift the AS curve to the right,

incentives to supply more must be made to producers. This is most commonly done by reducing the overall cost of production and/or increase the profit margin for the sales of products and services. Examples of how this can be done:

1) **Resource costs fall. *Ceteris paribus*, if the cost of resources required to produce a product or service are reduced, producers will generate more output since they are less restricted by the overall cost to produce.**

2) **Reduced taxes. Lower tax rates on wages and profits can increase the incentive for producers to supply more goods and services (Schiller 9th ed., 240)**

3) **Less costly regulation. Again, a reduction in the costs incurred by required government regulations (either by removing the regulatory requirements, or simply a less expensive way to comply with current required regulations) will reduce overall costs of production. Producers will have a higher profit margin if they increase their supply of products and services, *ceteris paribus*.**

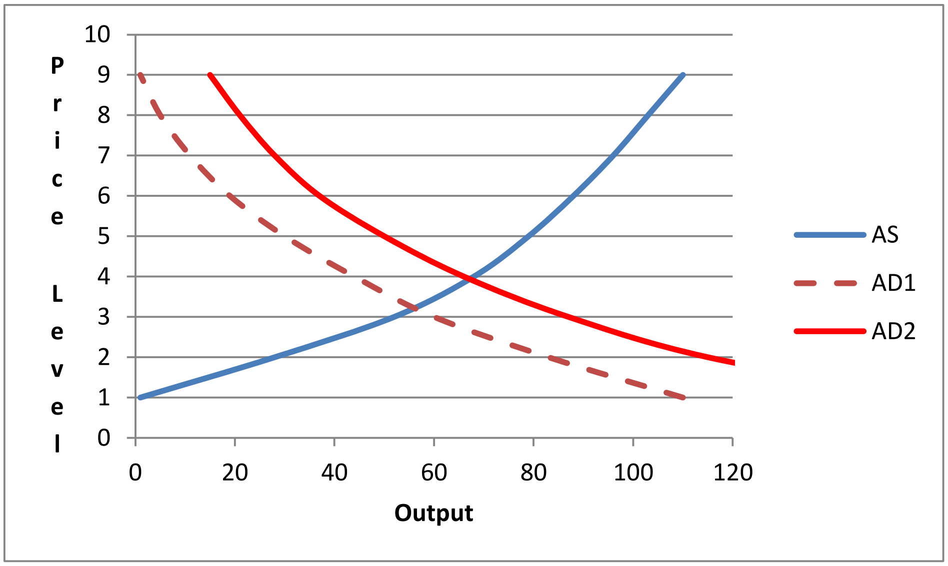
Very nice job on this one.

Problem 2

There has been extensive discussion of the "wealth effect." The argument goes that inflated stock values were partially responsible for the strong U.S. economy of the 1990's. Explain this linkage in words and then illustrate with an Aggregate Demand/Aggregate Supply diagram.

The wealth effect can be paraphrased as the effect wealth has on the economy: the wealthier people are, or perceive themselves to be, the higher consumer confidence will be and the more comfortable they will be with purchasing higher quantities or more expensive goods and services. Basically, the rise in stock prices increased the Aggregate Wealth (AW). This in turn increased AD since people had a higher level of wealth on paper, and could also get credit for larger loan amounts due to increased portfolios, etc. The shift to the right of the AD curve (from AD1 to AD2 on the graph) was resultantly a boon for producers, who could sell more, employ more people, increase their investment in their businesses, etc. I.E., there was a multiplier effect on the economy, benefitting the majority of the population.

Excellent work sorting this one out. Your graph is correct.



Problem 3

Explain the fundamental difference in the "Keynesian" view of the economy versus the "Classical" view.

The fundamental difference between Classical and Keynesian views can be summarized with one concept: Government Intervention.

According to the textbook, the Classical view emphasizes the ability of the market to "self-adjust". With the application of flexible prices and flexible wages, short term deviations from the long term economic trends were temporary, because the market would adjust to find a point of economic equilibrium. If producers have excess inventory due to lack of sales, they will adjust their prices to a point where consumers will be more willing to purchase them. This is reflected by Say's Law that states "Supply creates its own demand" [Schiller 9th ed, 227]. There was no need for government intervention because the market would take care of itself to adjust to an appropriate point.

The Great Depression showed that the Classical view is sometimes not valid. The Depression caused a tremendous shock to the economy, and the market didn't self-adjust to adapt to the huge unemployment and reduction in output. Keynes proposed that the private market is inherently unstable, and requires government intervention through policy levers (fiscal policy, government stimulus, etc) were necessary to protect jobs and income [Schiller, 228].

Another fine answer. You summarized each theory correctly and succinctly.

Problem 4

Would a millionaire and a poor person have the same MPC? Explain thoroughly.

MPC is a percentage of additional income spent on consumption, defined in the text as "The fraction of each additional (marginal) dollar of disposable income spent on consumption." So the MPC fraction is blind to the total value of an individual's propensity to consume. If you earn an additional $1 and choose to spend 75% of that (while saving the MPS of 25%), then you spend 75 cents of every dollar. If you earn an additional $100 and choose to spend 75%, you spend $75, which is still an average of 75 cents for every additional dollar earned. Additionally, it seems to me that MPC is a term that is intended more for Aggregate measurements (the economy as a whole) rather than individual consumers, so an Aggregate (nationwide) MPC would be an average of all propensity across the board to increase consumption, in addition to the benefits passed on via the multiplier effect to other industries.

Excellent job on the definitions, but this answer does not address the question posed which is to apply these definitions to two extreme examples. -4 points.

Problem 5

The federal government increases spending by $1 billion to develop a new fighter jet. If the MPC in the economy is 0.1, what will be the overall spending effect on the economy? Show your work.

Similar to the example of pg. 256 of the text, each spending cycle will by additive to the overall economic effect by 0.1 fraction of the previous cycle. So the initial spending of $1 Billion would create 2nd cycle spending of (.1) x $1B= $100 Million; 3rd cycle spending would be (.1) x $100M = $10M, etc. Instead of adding up all of these cycles ad infinitum, the multiplier formula shows us a logical limit to these effects in the form of: Multiplier = 1 / (1-MPC) [Schiller 9th ed, 256]. In this case, the multiplier would be 1/(1-.1) = 1.1111 (repeating), and the overall change in spending would be the initial $1B spent times the multiplier or $1.1111 billion

Your calculations are correct; excellent application of the multiplier formula.

Internet Questions

Question 1

Visit: http://taxhistory.tax.org

Go explore the Tax History Museum. While there, select the dates 1861 to 1865. Provide a synopsis on the relative approaches taken by the North and the South with regard to tax policy. Which was superior and why?

All quotes in the following answer are taken directly from the Tax History Museum website.

The intro paragraph of this site explains that "the varying fiscal strategies undertaken by the Union and Confederate governments undoubtedly influenced the capacity of both societies to sustain the war effort. North and South employed markedly different approaches. The North's proved more efficacious in the long run."

After working to interpret the pompous writing style of the author, my analysis of his (or her) synopsis is as follows:

- **Confederate (South): Taxes were predominantly collected by the States to conduct State business. There was initially little means to produce or collect Federal revenues. The Confederate gov't attempted to impose tariffs, levy property tax, and finance with bond sales to increase revenue, but had only a moderate effect. As a solution to increasing revenue, they printed more money instead of implementing and enforcing taxes. However, so did individual States. Because there was no requirement to utilize the Federal Confederate currency, the production of State currency diluted the value of Confederate currency. Ultimately, there was a 9,000% inflation rate by end of war. Eventually, several alternative taxation methods were finally attempted, finally moving to direct taxation after a change in the tax law, but this occurred too late in the war to have any significant impact.**

- **Union (North): Entered the war with an already established Tariff and treasury structure, as well as a developed industry base. They imposed several taxes and tariffs, including an income tax that was directly taken from the paychecks of laborers (avoiding the need to have tax collectors, and bringing revenue directly to the Federal Treasury). According to the article: "**The Union government's decision to implement a broad system of internal taxation not only insured a valuable source of income, but shielded the northern economy from the sort of ruinous inflation experienced by the South."

- **In time, the enforced income and property taxes added significantly more to the Union coffers when compared to that of the Confederates: "**10 percent of all Union households had paid some form of income tax by war's end; residents of the northeast comprised 15 percent of that total. In fact, the northeast, a sector of American society that owned 70 percent of the nation's wealth in 1860, provided the most critical tax base, remitting 75 percent of the revenues. In total, the North raised 21 percent of its war revenue through taxation, as opposed to the South, which raised just 5 percent this way."

Summarizing, the North was more successful because they implemented income and property taxes that were directly retrieved, and the Treasury produced money that was backed by the Federal government, but also required to be used as legal tender, minimizing counterfeit attempts. In contrast, the South tried imposing taxes, but relied on the States to retrieve it for them, which didn't happen very successfully. They also printed money from the treasury (like the North), but didn't establish the

Federal currency as the primary means of paying for consumption. Because the Confederate States also had their own versions of currency, the Federal currency became devalued, and inflation skyrocketed. Apparently, the Union won in more ways than just on the battle field!

Fabulous job on this essay and summary of history.