

Study Problem: A Menu of Keynesian Fiscal Policy

Combating Unemployment in Aguablanca

The small country of Aguablanca is populated with spendthrifts. Out of each extra dollar of income earned, the Aguablangans save only one nickel. However, Aguablanca is currently settled into a (Keynesian) equilibrium in which consumers are spending \$800 million, investors are spending \$150 million, and the government is spending \$50 million. Full-employment income is judged to be \$1,760 million. Answer the questions below on the basis of this information.

1. In the current income-expenditure equilibrium, people are earning a total income of
A. \$200. B. \$800. C. \$1,000. D. \$1,760.
2. The marginal propensity to consume in Aguablanca is
A. 0.66. B. 0.80. C. 0.90. D. 0.95.
3. Given the saving behavior in Aguablanca, we can say that its government-spending multiplier is
A. 9. B. 10. C. 19. D. 20.
4. Accordingly, Aguablanca's tax multiplier is
A. -9. B. -10. C. -19. D. -20.
5. The so-called balanced-budget multiplier in Aguablanca is
A. 1. B. 10. C. -1. D. -10.

To achieve full employment without inflation, three *alternative* policies are offered for consideration:

- Policy 1: Decrease taxes by \$40 million.
- Policy 2: Increase government spending by \$40 million.
- Policy 3: Increase taxes by \$760 million and increase government spending by that same amount.

Provide a Keynesian evaluation of *each* policy. Which, if any, will result in full employment without inflation in Aguablanca? Report your conclusions by choosing the correct responses below.

6. Policy 1 will result in
A. unemployment and inflation. C. unemployment but no inflation.
B. full employment with inflation. D. full employment without inflation.
7. Policy 2 will result in
A. unemployment and inflation. C. unemployment but no inflation.
B. full employment with inflation. D. full employment without inflation.
8. Policy 3 will result in
A. unemployment and inflation. C. unemployment but no inflation.
B. full employment with inflation. D. full employment without inflation.
9. If investment decisions in Aguablanca were grounded in economics rather than psychology, and if prices, nominal wage rates, and real wage rates were flexible, what would be the most appropriate policy?
A. a balanced-budget stimulant. C. deficit spending.
B. a tax on inflation. D. *laissez-faire*.