Practice Free Response Questions **Name** ______________________________

1. The economy is at full employment. An increase in government spending causes the government deficit to increase.

(a) **Draw** an aggregate supply and demand graph showing the economy at full employment. **Show on the graph** and explain completely the impact of the increase in government spending on each of the following.

(i) Price level
(ii) Real Output

(b) **Explain** how the increase in the deficit will affect each of the following in the long run.

(i) Nominal interest rates
(ii) Real interest rates

(c) Define each of the following

(i) Government deficit
(ii) National debt

(d) Do each of the following.

(i) Identify one tax policy the government could use to promote long-run economic growth in this economy.

(ii) **Explain** how this tax policy will promote long-run growth.

(iii) **Draw** a production possibilities curve for this economy that produces capital goods and consumption goods. **Show** how this tax policy will affect this economy's production possibilities curve

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2. Suppose that the U.S. economy is in a deep recession.

(a) Using a correctly labeled aggregate demand and aggregate supply graph, show the equilibrium price level and real gross domestic product.

(b) There is a debate in Congress as to whether to decrease personal income taxes by a given amount or to increase government purchases by this amount. Which of these two fiscal policies will have a larger impact on real gross domestic product? Explain.

(c) Explain how a decrease in personal income taxes will affect each of the following in the short run.

(i) Consumption
(ii) Real gross domestic product and the price level
(iii) Imports
(iv) Exports

(d) Explain the mechanism by which an increase in net investment will cause each of the following to change.

(i) Aggregate demand
(ii) Long-run aggregate supply

3. Assume that the economy is operating below the full-employment level of output and that the government budget is balanced.

(a) Using a correctly labeled aggregate demand and aggregate supply graph, show how an increase in government spending will affect each of the following in the short-run.

(i) Real Output (ii)

Price level

(b) Explain how this increase in government spending will affect each of the following in the short-run.

(i) Real interest rates (ii)

Investment

Now assume that instead of increasing government spending, the government decreases corporate-profits taxes.

(c) Using a correctly labeled aggregate demand and aggregate supply graph, show and explain how this decrease in corporate-profits taxes will affect each of the following.

(i) Aggregate demand
(ii) Long-run aggregate supply
(iii) Real output
(iv) Price level

(d) Assume that this country produces two goods, X and Y. Draw a correctly labeled production possibilities curve for this economy. Now show on the graph how this decrease in corporate-profits taxes will affect this economy's production possibilities curve.

AP Economics **Name** ____________________

Practice Free Response

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