Worksheet 12

Subject: Economics   Year / Level: 13   Name: _____

Strand	3 - Macroeconomics
Sub Strand	3.2 Income and Expenditure Analysis
Content Learning Outcome	3.2.1 Analyze the income and expenditure analysis.

Policies to eliminate inflationary and deflationary gaps

Eliminating inflationary gap

➢ The consequence is that due to deflationary gap all the resources of the economy are <u>not being used in the optimum level and they are idle.</u> This results in <u>unemployment</u> and <u>low level of output</u>. This is **not desirable** for any government. **In order to reduce/eliminate the deflationary gap, the government uses expansionary fiscal policy.**

➢ Government will either <u>increase its spending or reduce taxes</u> (or both) in order to stimulate the aggregate demand. Increase <u>Government spending will result me more projects being funded by the government and thus employment and output will increase.</u> Even a <u>lower tax rate will result in more disposable income for households and encourage consumption</u>. Increased G and C will lead to higher AD.
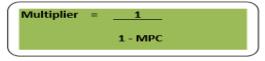
Eliminating deflationary gap

➢ In case of inflationary gap the government can use **<u>contractionary fiscal</u>** policy to control inflation and bring down the AD.
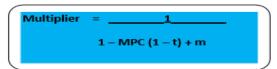
Multiplier is the coefficient which relates to a given change in the expenditure to a final change in the level of income.

Multiplier effect is the notion that an autonomous change in the level of spending will give rise to an even *large change* in the equilibrium level of income.

Multiplier in Simple Economy

$$\text{Multiplier} = \frac{1}{1 - MPC}$$

Multiplier in Open Economy

$$\text{Multiplier} = \frac{1}{1 - MPC(1 - t) + m}$$

Activity 1

> In an economy, **autonomous consumption** expenditure is $100 billion, investment is $200 billion and government expenditure on goods and services is $250 billion. The marginal propensity to consume is 0.7 and net taxes are $50 billion. Exports are $500 billion and imports are $450 billion. Assume that net taxes and imports are autonomous. Price is constant.

(i)   Define **autonomous consumption**.   (1 mark)

(ii) Determine the consumption function.   (1 mark)

(iii) Calculate the equilibrium expenditure.   (2 marks)

Activity 2

$$C = \$50m + 0.75Y$$

$$I = \$30m$$

$$G = \$25m$$

$$X = \$30m$$

$$M = \$15m + 0.1Y$$

(i)   Is the economy stated above an open or a closed economy?
      Provide a reason.   (2 marks)

(ii) Calculate equilibrium level of **Real GDP(Y)**.
      (Gross Domestic Product)   (2 marks)

(iii) Calculate the **change in GDP** if government spending increased by $10m. (1 mark)

Activity 3

$C = \$100 + 0.90YD$ (Private Consumption)
$YD = Y - T$ (Disposable Income)
$G = \$400m$ (Government Expenditure)
$I = \$460m$ (Private Investment)
$T = \$440m$ (Total Taxes)

(i)   Define **Autonomous Consumption**.   (1 mark)

(ii) Derive the **Autonomous Expenditure** equation.   (1 mark)

(iii) Calculate **Real GDP(Y)**.   (2 marks)

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