

Place your name on the back of this sheet of paper and nowhere else. Staple your answers face up on the front of this sheet of paper. Failure to follow these directions will cost you 1 point. Your assignment will be typed, except graphs can be drawn by hand and mathematical equations can be done by hand. Failure to type it will cost you 10 points. If you use double-sided printing or print on the back of scrap paper, I will give you one additional point.

1) (25 points) Draw the Keynesian Cross, a.k.a. 45° diagram. Illustrate the effects of an increase in government spending. Explain why the graph moved as drawn. Given your diagram, what is the size of the government spending multiplier? Explain how you reached that conclusion. Why isn't your answer equal to the 10 we estimated in class?

2) (20 points) When we calculated the government spending multiplier, we made many assumptions. What did we assume about the income tax? If we relax that assumption, then what will happen to the size of the multiplier? Explain your logic.

3) (15 points) What is meant by *crowding out*? Why should that be a big concern for a country?

4) (20 points) What is *Ricardian Equivalence*? What does that mean about the effectiveness of fiscal policy? Explain your logic.

5) (20 points) What is meant by *lags* in fiscal policy? Explain how they might mean we may not want to do fiscal policy, even if it works.