1. Suppose the Republican ticket of George W. Bush and Dick Cheney wins the 2000 election and immediately cuts personal income tax rates. Personal income taxes lower the return on both labor and capital and therefore a reduction in personal income tax rates will lead households to supply more labor (through labor supply) and more capital (through saving). The following question asks you to assess the long- and short-run implications of their policy.

   a. Using the labor market and production function diagrams of chapters 21 and 23, show the long-run effect of the Republican policy on the equilibrium real wage ($w^*$), quantity of labor ($L^*$) and level of real GDP ($Y^*$).

   b. Using the nongovernmental spending diagram of chapter 22, show the long-run effect of the Republican policy on the equilibrium interest rate ($R^*$). As a result, what would happen to the consumption share ($C/Y$), investment share ($I/Y$) and net export share ($X/Y$)?

   c. Using the AD/inflation-price adjustment diagram of chapter 27, show the short-run effect of the Republican policy on the inflation rate ($\pi$) and the level of real GDP ($Y$). Explain why real GDP ($Y$) would increase in the short-run.

   d. Using the AD/inflation-price adjustment diagram of chapters 27 and 28, show the long-run effect of the Republican policy on the inflation rate ($\pi$) and the level of real GDP ($Y^*$). Remember that potential GDP ($Y^*$) may have changed.

2. Suppose the Democratic ticket of Al Gore and Joseph Lieberman wins the 2000 election and immediately raises government spending ($G/Y$) for worker training and education. More worker training and education raises the marginal product of labor ($MPL$). The following question asks you to assess the long- and short-run implications of their policy.

   a. Using the labor market and production function diagrams of chapters 21 and 23, show the long-run effect of the Democratic policy on the equilibrium real wage ($w^*$), quantity of labor ($L^*$) and level of real GDP ($Y^*$).

   b. Using the nongovernmental spending diagram of chapter 22, show the long-run effect of the Democratic policy on the equilibrium interest rate ($R^*$). As a result, what would happen to the consumption share ($C/Y$), investment share ($I/Y$) and net export share ($X/Y$)?

   c. Using the AD/inflation-price adjustment diagram of chapter 27, show the short-run effect of the Democratic policy on the inflation rate ($\pi$) and the level of real GDP ($Y$). Explain why real GDP ($Y$) would increase in the short-run.
d. Using the AD/inflation-price adjustment diagram of chapters 27 and 28, show the long-run effect of the Democratic policy on the inflation rate ($\pi$) and the level of real GDP ($Y$). Remember that potential GDP ($Y^*$) may have changed.

3. Alan Greenspan, chairman of the Federal (Reserve) Open Market Committee (FOMC), has publicly expressed his concern that the expansionary policies of either George W. Bush or Al Gore will lead to inflation.

a. Drawing upon your answers in questions 1 and 2, should Alan Greenspan be concerned? Explain why or why not.

b. If Alan Greenspan is indeed concerned about inflation, what should he do to the Federal Reserve’s monetary policy rule? You may use the monetary policy rule diagram on pages 733, 738 and 756 to aid in your discussion.

c. Using the AD/inflation-price adjustment diagram of chapters 27 and 28, show the short-and long-run effect of the Federal Reserve’s monetary policy response on the inflation rate ($\pi$) and the level of real GDP ($Y$). To isolate the effects of the Federal Reserve’s policy, do not include the effects of either the Republican or Democratic fiscal policy.

d. Using the results from part c, explain how the Federal Reserve’s policy may harm the economy in the short-run but help the economy in the long-run.