1. The 1.6 trillion dollar tax cut of President George W. Bush calls for across the board reductions in personal income tax rates. Personal income taxes lower the after-tax wage rate. Therefore, if personal income taxes are cut, households will supply more labor. The following asks you to assess the long-run implications of this policy.

   a. Using the labor market and production function diagrams of chapters 21 and 23, show the long-run effects 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 effects 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 quantity equation of chapter 24, show the long-run effect of the Republican policy on the price level ($P$).

2. Suppose the economy is currently operating below potential GDP (current real GDP is less than potential GDP). Using the AD/inflation-price adjustment diagram of chapters 27-29, show the short-run and long-run effects of the 1.6 trillion dollar tax cut of President George W. Bush.

   a. Show the short-run effects of the tax cut on the inflation rate ($\pi$) and the level of real GDP ($Y$). Explain why real GDP ($Y$) would increase in the short-run.

   b. Show the long-run effects of the tax cut on the inflation rate ($\pi$) and the level of real GDP ($Y$).

3. Suppose instead that the economy is currently operating at potential GDP (current real GDP is equal to potential GDP). Using the AD/inflation-price adjustment diagram of chapters 27-29, show the short-run and long-run effects of the 1.6 trillion dollar tax cut of President George W. Bush.

   a. Show the short-run effects of the tax cut on the inflation rate ($\pi$) and the level of real GDP ($Y$).

   b. Show the long-run effects of the tax cut on the inflation rate ($\pi$) and the level of real GDP ($Y$). Explain why real GDP ($Y$) returns to potential GDP in the long-run.
4. Alan Greenspan, chairman of the Federal (Reserve) Open Market Committee (FOMC), has expressed some concern that the tax cut of President George W. Bush may lead to inflation. Drawing upon your answers in question 3, answer the following:

a. Should Alan Greenspan be concerned with inflation? 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 money market of chapter 30, show how the Federal Reserve can raise its short-term interest rate target.

d. Using the AD/inflation-price adjustment diagram of chapters 27-29, show the short-run effects of the Federal Reserve’s monetary policy response on the inflation rate ($\pi$) and the level of real GDP ($Y$).

e. Using the AD/inflation-price adjustment diagram of chapters 27-29, show the long-run effects of the Federal Reserve’s monetary policy response on the inflation rate ($\pi$) and the level of real GDP ($Y$).