CHAPTER 18
Deficits, Surpluses, and the Public Debt

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Multiple Choice Questions

Definitions: deficits, surpluses, debt

1. The U.S. public debt:
   A) refers to the debts of all units of government--Federal, state, and local.
   B) consists of the total debt of U.S. households, businesses, and government.
   C) refers to the collective amount that U.S. citizens and businesses owe to foreigners.
   D) consists of the historical accumulation of all Federal government deficits and surpluses.
   Answer: D

2. The Federal budget deficit is found by:
   A) subtracting government tax revenues plus government borrowing from government spending in a particular year.
   B) subtracting government tax revenues from government spending in a particular year.
   C) cumulating the differences between government spending and tax revenues over all years since the nation's founding.
   D) subtracting government revenues from the noninvestment-type government spending in a particular year.
   Answer: B

3. The amount by which government expenditures exceed revenues during a particular year is the:
   A) public debt.
   B) budget deficit.
   C) full-employment.
   D) GDP gap.
   Answer: B
4. The amount by which Federal tax revenues exceed Federal government expenditures during a particular year is the:
   Answer: C

5. The Federal budget surplus is found by:
   A) subtracting government revenue plus government borrowing from government spending in a particular year.
   B) cumulating the difference between government spending and tax revenues over all years since the nation's founding.
   C) subtracting government revenues from government spending on noninvestment goods in a particular year.
   D) subtracting government spending from government tax revenue in a particular year.
   Answer: D

6. The public debt is the amount of money that:
   A) state and local governments owe to the Federal government.
   B) Americans owe to foreigners.
   C) the Federal government owes to holders of U.S. securities.
   D) the Federal government owes to taxpayers.
   Answer: C

7. The public debt is held as:
   A) U.S. securities, corporate bonds, and common stock.
   B) Federal Reserve Notes.
   C) U.S. gold certificates.
   D) Treasury bills, Treasury notes, Treasury bonds, and U.S. savings bonds.
   Answer: D

Use the following to answer questions 8-10:

<table>
<thead>
<tr>
<th>Security</th>
<th>Amount (in billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Treasury bills</td>
<td>$220</td>
</tr>
<tr>
<td>Corporate bonds</td>
<td>140</td>
</tr>
<tr>
<td>Treasury notes</td>
<td>80</td>
</tr>
<tr>
<td>Corporate stock</td>
<td>200</td>
</tr>
<tr>
<td>U.S. saving bonds</td>
<td>60</td>
</tr>
<tr>
<td>Treasury bonds</td>
<td>100</td>
</tr>
</tbody>
</table>

8. The public debt for the above economy is:
   A) $540 billion.  B) $400 billion.  C) $580 billion.  D) $460 billion.
   Answer: D
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9. Other things equal, an increase of Treasury bonds from $100 billion to $120 billion in the above economy would:
   A) not change the size of the public debt.
   B) increase the public debt from $460 billion to $480 billion.
   C) increase the public debt from $400 billion to $420 billion.
   D) decrease the public debt by $20 billion.
   Answer: B

10. Other things equal, an increase of corporate bonds from $140 billion to $150 billion in the above economy would:
    A) not change the size of the public debt.
    B) increase the public debt from $460 billion to $470 billion.
    C) increase the public debt from $600 billion to $610 billion.
    D) decrease the public debt by $20 billion.
    Answer: A

11. Suppose the Federal government had budget deficits of $40 billion in year 1 and $50 billion in year 2 but had budget surpluses of $20 billion in year 3 and $50 billion in year 4. Also assume that it used its budget surpluses to pay down the public debt. At the end of these four years, the Federal government's public debt would have:
    A) increased by $90 billion.
    B) increased by $20 billion.
    C) decreased by $70 billion.
    D) decreased by $20 billion.
    Answer: B

12. Suppose the Federal government had budget surpluses of $80 billion in year 1 and $120 billion in year 2 but had budget deficits of $10 billion in year 3 and $40 billion in year 4. Also assume that it used its budget surpluses to pay down the public debt. At the end of these four years, the Federal government's public debt would have:
    A) increased by $50 billion.
    B) increased by $150 billion.
    C) decreased by $200 billion.
    D) decreased by $150 billion.
    Answer: D
Use the following to answer questions 13-18:

Answer the next question(s) using the following budget information for a hypothetical economy. Assume that all budget surpluses are used to pay down the public debt.

<table>
<thead>
<tr>
<th>Government spending</th>
<th>Tax revenues</th>
<th>GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>$450</td>
<td>$425</td>
</tr>
<tr>
<td>Year 2</td>
<td>500</td>
<td>450</td>
</tr>
<tr>
<td>Year 3</td>
<td>600</td>
<td>500</td>
</tr>
<tr>
<td>Year 4</td>
<td>640</td>
<td>620</td>
</tr>
<tr>
<td>Year 5</td>
<td>680</td>
<td>580</td>
</tr>
<tr>
<td>Year 6</td>
<td>600</td>
<td>620</td>
</tr>
</tbody>
</table>

13. Refer to the above data. If year 1 is the first year of this nation's existence and year 6 is the present year, this nation's public debt is:
   A) $275 billion. B) $100 billion. C) $3540 billion. D) $230 billion.
   Answer: A

14. Refer to the above data. The budget deficit in year 3 is:
   A) $175 billion. B) $3050 billion. C) $100 billion. D) $295 billion.
   Answer: C

15. Refer to the above data. If year 1 is the first year of this nation's existence and year 4 is the present year, the public debt as a percentage of GDP in year 4 is:
   A) 7.5 percent. B) 1.39 percent. C) 2.5 percent. D) 3.9 percent.
   Answer: D

16. Refer to the above data. A budget surplus occurred in year:
   A) 2 B) 3 C) 4 D) 6
   Answer: D

17. Refer to the above data. The public debt declined in year:
   A) 6 B) 5 C) 4 D) 3
   Answer: A

18. Refer to the above data. As a percentage of GDP, the:
   A) budget deficit was 3.9 percent in year 4.
   B) budget surplus was less than 1 percent in year 6.
   C) public debt was 3 percent in year 6.
   D) public debt was 12.5 percent in year 1.
   Answer: B
19. Which of the following statements is not correct?
A) State and local governments in the aggregate have realized budget surpluses in some years.
B) A Federal deficit of $20 billion in 2002 would increase the public debt by $20 billion.
C) The public debt is the accumulation of all the Federal government's deficits and surpluses.
D) The public debt refers to the debts of all units of government--Federal, state, and local.
Answer: D

Budget philosophies

20. Fiscal conservatives favor an annually balanced budget primarily because they:
A) believe the private sector is inherently unstable.
B) believe the public debt will soon cause the Federal government to go bankrupt.
C) believe deficit financing leads to an undesirable expansion of the public sector of the economy.
D) fear interest payments on the debt will increase income inequality.
Answer: C

21. An annually balanced budget intensifies the business cycle because tax revenue declines associated with:
A) prosperity will require cuts in government spending.
B) recession will require increases in government spending.
C) prosperity will require cuts in government spending.
D) recession will require cuts in government spending.
Answer: D

22. If government adhered strictly to an annually balanced budget, then during a recession:
A) expenditures and tax collections would remain unchanged.
B) both expenditures and tax rates would have to be decreased.
C) both expenditures and tax rates would have to be increased.
D) expenditures would have to be reduced and/or tax rates increased.
Answer: D

23. If government adhered strictly to an annually balanced budget, the government's budget would:
A) reduce the size of the public debt.  
B) intensify the business cycle.  
C) have no impact on real GDP.  
D) stabilize the economy.
Answer: B

24. The idea of a cyclically balanced budget is for government to:
A) balance the economy, not worrying about expansion of the public debt.
B) balance the budget over ten-year periods.
C) exactly match budget deficits accruing in the recession phase of the business cycle with surpluses occurring in the late recovery phase.
D) make sure the full-employment deficit is always zero.
Answer: C
25. A major criticism of a cyclically balanced budget is that:
   A) tax revenues automatically fall in recessions, but do not automatically increase in expansions.
   B) automatic (built-in) stabilizers are so effective that discretionary fiscal policy is unnecessary.
   C) such a policy has an inflationary bias.
   D) upswings and downswings of the business cycle are not always of equal magnitude and duration.
   Answer: D

26. Functional finance:
   A) is designed to increase the MPC to achieve greater macroeconomic stability.
   B) requires annually balanced budgets.
   C) views the public budget primarily as a way to stabilize the economy.
   D) is supported mainly by monetarists.
   Answer: C

27. Functional finance contends that:
   A) the Federal budget should be balanced, not annually, but rather over the business cycle.
   B) the Federal budget should be used primarily to alter the allocation of resources and not to stabilize the economy.
   C) automatic stabilizers are so effective that discretionary fiscal policy is unnecessary.
   D) the primary purpose of the Federal budget is to stabilize the economy and balancing the budget as such is of far lesser importance.
   Answer: D

28. The idea that the basic purpose of the Federal budget is to stabilize the economy regardless of any resulting changes in the size of the public debt best describes:
   A) a socially optimal budget.  C) a cyclically balanced budget.
   B) functional finance.  D) an annually balanced budget.
   Answer: B

29. A proponent of functional finance would say that:
   A) the budget must balanced, but only over the course of an entire business cycle.
   B) balancing the budget is not the most important objective of fiscal policy.
   C) the public debt should be reduced during recessions and increased during inflations.
   D) balancing the budget is the primary goal of fiscal policy.
   Answer: B

30. The problems associated with a growing public debt are modest when compared with the costs entailed by recession and unemployment. This statement reflects the idea of:
   A) the balanced-budget multiplier.  C) functional finance.
   B) the full-employment budget.  D) the crowding-out effect.
   Answer: C
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Public debt causes and facts

31. Which of the following is not a significant contributor to the U.S. public debt?
   A) war financing   C) recessions
   B) tax cuts and expenditure increases in the 1980s   D) demand-pull inflation
   Answer: D

32. Recessions have contributed to the public debt by:
   A) reducing national income and therefore tax revenues.
   B) increasing real interest rates.
   C) increasing the international value of the dollar.
   D) increasing national saving.
   Answer: A

33. The deep cut in tax rates in the early 1980s:
   A) increased tax revenues, reduced budget deficits, and slowed the growth of the public debt.
   B) were unaccompanied by expenditure reductions and therefore increased the public debt.
   C) was accompanied by equally deep cuts in Federal spending, thus neither increased nor decreased the public debt.
   D) contributed to rising budget deficits, but not to a rising public debt.
   Answer: B

34. Which of the following statements is correct?
   A) Federal deficits were larger in the late 1990s than in the early 1990s.
   B) Deep tax cuts always expand tax revenues and reduce the public debt.
   C) The public debt has usually declined during wartime.
   D) There is a tendency for the public debt to grow during recessions.
   Answer: D

35. In 2002, the public debt was:
   A) held largely by foreign governments.   C) about twice as large as the GDP.
   B) about four times as large as the GDP.   D) about 59 percent as large as the GDP.
   Answer: D

36. In 2002, the public debt was about:
   A) $6.2 trillion.   B) $1 trillion.   C) $470 billion.   D) $320 billion.
   Answer: A
37. Between 1995 and 2000, the public debt:
   A) remained constant absolutely, but declined as a percentage of the GDP.
   B) declined absolutely, but remained constant as a percentage of the GDP.
   C) declined as a percentage of the GDP.
   D) increased as a percentage of the GDP.
   Answer: C

38. The average tax rate required to service the public debt is roughly measured by:
   A) the absolute size of the debt.
   B) the debt as a fraction of the GDP.
   C) interest on the debt as a percentage of the GDP.
   D) the ratio of government spending to the GDP.
   Answer: C

39. As a percent of GDP, the United States public debt is:
   A) the highest among major industrial nations.
   B) the lowest among major industrial nations.
   C) lower than the public debts of several other major industrial nations.
   D) higher than the percentages for Canada, Germany, and Italy.
   Answer: C

40. What percentage of the U.S. public debt is held by Federal agencies and the Federal Reserve?
   A) 50 percent  B) 67 percent  C) 43 percent  D) 11 percent
   Answer: C

41. What percentage of the public debt is held by foreign individuals and institutions?
   A) 18 percent  B) 2 percent  C) 33 percent  D) 50 percent
   Answer: A

42. The portion of the public debt held outside Federal agencies and the Federal Reserve is:
   A) substantially larger than the portion held by Federal Agencies and the Federal Reserve.
   B) about half as large as the portion held by Federal Agencies and the Federal Reserve.
   C) equally split between U.S. and foreign lenders.
   D) includes U.S. saving bonds, but not Treasury bills, Treasury notes, and Treasury bonds.
   Answer: A

43. The largest proportion of the public debt is held by:
   A) the U.S. public (individuals, businesses, financial institutions, etc.) and state and local governments.
   B) foreign individuals and institutions.
   C) the Federal Reserve System.
   D) the U.S. Treasury.
   Answer: A
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44. If monies added to, or subtracted from, the Social Security trust fund were excluded from Federal budget calculations, the current Federal budget:
   A) deficit would nearly disappear.  C) surplus would nearly disappear.
   B) deficit would be substantially larger.  D) surplus would be substantially smaller.
   Answer: B

45. The Social Security trust fund currently is in:
   A) deficit, and it inclusion in the Federal budget increases the stated size of the budget deficit.
   B) deficit, and it inclusion in the Federal budget reduces the stated size of the budget deficit.
   C) surplus, and its inclusion in the Federal budget reduces the stated size of the budget deficit.
   D) surplus, and it inclusion in the Federal budget increases the stated size of the Federal budget deficit.
   Answer: C

46. About ____ percent of the U.S. public debt is held by people and institutions abroad.
   A) 40  B) 8  C) 18  D) 33
   Answer: C

47. About ____ percent of the U.S. public debt is held by the Federal government and Federal Reserve.
   A) 10  B) 21  C) 62  D) 43
   Answer: D

Domestic economic implications

48. To say that "the U.S. public debt is also a public credit" is to say that:
   A) only interest payments on the public debt are an economic burden.
   B) official figures understate the size of the public debt.
   C) the bulk of the public debt is owned by U.S. citizens and institutions.
   D) the public debt is equal to the land and buildings assets owned by the Federal government.
   Answer: C

Type: A  Topic: 4  E: 328  MA: 328
49. Payment of interest on the U.S. public debt:
   A) increases the current domestic standard of living in the United States.
   B) has no effect on the distribution of income.
   C) is thought to decrease income inequality.
   D) is thought to increase income inequality.
   Answer: D

50. The most likely way the public debt burdens future generations, if at all, is by:
   A) reducing the current level of investment.  C) causing deflation.
   B) causing future unemployment.  D) reducing real interest rates.
   Answer: A
51. Other things equal, the stock of capital inherited by future generations is likely to be smaller when government spending:
   A) increases during a period of recession, rather than prosperity.
   B) is primarily for capital-type goods.
   C) is financed by borrowing.
   D) is financed by taxation.
   Answer: C

52. The crowding-out effect suggests that:
   A) tax increases are paid primarily out of saving and therefore are not an effective fiscal device.
   B) government borrowing to finance the public debt increases the real interest rate and reduces private investment.
   C) it is very difficult to have excessive aggregate spending in a capitalist economy.
   D) consumer and investment spending always vary inversely.
   Answer: B

53. The Federal government has a large public debt that it finances through borrowing. As a result, real interest rates are higher than otherwise and the volume of private investment spending is lower. This illustrates the:
   Answer: C

54. The real burden of an increase in the public debt:
   A) may be very small or conceivably zero when the economy is in a severe depression.
   B) will be smaller when full employment exists than when the economy has large quantities of idle resources.
   C) can be shifted to future generations if the debt is internally financed.
   D) can best be measured by the dollar increase in the size of the debt.
   Answer: A

55. Which one of the following might offset a crowding-out effect of financing a large public debt?
   A) a decline in net exports  C) a decrease in the money supply
   B) an increase in public investment  D) a decline in public investment
   Answer: B
Use the following to answer questions 56-57:

56. Refer to the above diagram. Initially assume that the investment demand curve is ID₁. The crowding-out effect of a large public debt would be shown as a(n):
   A) shift of the investment demand curve from ID₁ to ID₂.
   B) leftward shift of the investment demand curve.
   C) increase in the interest rate from 4 percent to 6 percent and a decline in investment spending of $5 billion.
   D) increase in the interest rate from 6 percent to 8 percent and a decline in investment spending of $40 billion.
   Answer: C

57. Refer to the above diagram. Initially assume that the investment demand curve is ID₁. Which of the following effects of financing a large public debt might shift the investment demand curve from ID₁ to ID₂, wholly offsetting any crowding-out effect?
   A) an improvement in profit expectations by businesses
   B) a decrease in saving
   C) a decline in the interest rate
   D) an increase in the marginal propensity to consume
   Answer: A

58. Which of the following is the best example of public investment?
   A) salaries of Senators and Representatives
   B) government expenditures on food stamps
   C) construction of highways
   D) funding of regulatory agencies
   Answer: C
59. The true size of Federal budget deficits may be understated because:
   A) a portion of government spending is public investment.
   B) inflation reduces the real value of the public debt.
   C) Social Security surpluses are included as government tax revenues in measuring the budget deficit.
   D) foreign holdings of the debt have recently increased.
   Answer: C

60. Which of the following allegedly understates the true size of the Federal budget deficit?
   A) inclusion of government spending on the savings and loan (S&L) bailout
   B) inclusion of the Social Security surplus
   C) inclusion of Federal excise tax receipts
   D) inclusion of current transfer payments
   Answer: B

Deficits and surpluses: 1992 - 2012

61. The Deficit Reduction Act of 1993:
   A) imposed Federal property taxes for the first time.
   B) increased the excise tax on gasoline by 50 cents a gallon.
   C) increased the top marginal tax rate on personal income to 39.6 percent.
   D) reduced government spending by $2 for each $1 increase in taxes.
   Answer: C

62. The Deficit Reduction Act of 1993:
   A) equalized the top marginal tax rates on personal and corporate income.
   B) slightly raised the corporate income tax rate.
   C) replaced the corporate income tax with a national sales tax.
   D) cut government spending programs, but did not increase taxes.
   Answer: B

63. The main focus of U.S. economic policy in the first half of the 1990s was:
   A) creating an expansionary fiscal policy.
   B) reducing Federal budget deficits and lowering real interest rates.
   C) enacting a contractionary monetary policy.
   D) reducing the trade deficit.
   Answer: B

64. Between 1990 and 1997, the U.S. had annual ______, whereas between 1998 and 2000 it had annual ______.
   A) trade deficits; trade surpluses
   B) trade surpluses, trade deficits
   C) budget deficits; budget surpluses
   D) budget surpluses; budget deficits.
   Answer: C
In 2001, Federal budget surpluses were projected to cumulate to:

A) $2 trillion by 2010.  
B) $5 trillion by 2010  
C) $10 trillion by 2005.  
D) $20 trillion by 2020.

Answer: B

Advocates of using the actual and projected budget surpluses of the late 1990s to pay down the public debt said that this policy would:

A) reduce interest rates, increase private investment, and increase economic growth.
B) increase take-home pay, reduce consumption spending, and increase economic growth.
C) reduce exports and increase imports.
D) enhance the Fed's ability to conduct monetary policy through open-market operations.

Answer: A

Advocates of using the actual and projected budget surpluses of the late 1990s to reduce taxes said that this policy would:

A) reduce interest rates, increase private investment, and increase economic growth.
B) return surplus revenue to taxpayers and limit the growth of government spending.
C) preserve the long-term health of the social security system by bolstering the social security trust fund.
D) lower the natural rate of unemployment.

Answer: B

Advocates of using the actual and projected budget surpluses of the late 1990s to pay for new social programs such as Medicare coverage for prescription drugs said these programs would:

A) reduce interest rates, increase private investment, and increase economic growth.
B) lower the natural rate of unemployment.
C) boost consumer and business confidence and promote economic growth.
D) enhance the nation's well-being.

Answer: D

Advocates of using the actual and projected budget surpluses of the late 1990s to bolster the social security trust fund said that:

A) the number of older Americans will increase substantially over the next several decades, eventually straining the Social Security system.
B) this policy would boost interest rates, increase saving, and increase private investment.
C) this policy would enable deep cuts in the payroll tax used to finance social security.
D) without such a policy, the Social Security system will go bankrupt in 2010.

Answer: A

Annual budget deficits gave way to annual budget surpluses beginning in:

A) 1982.  
B) 1989.  
C) 1993.  
D) 1998.

Answer: D
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71. In 2002 and 2003, the United States had:
A) large Federal budget surpluses.  
B) large Federal budget deficits.  
C) modest trade surpluses.  
D) a rising natural rate of unemployment.
Answer: B

72. Which of the following is a true statement?
C) The swing from budget surpluses in the late 1990s to budget deficits in the early 2000s resulted exclusively because of a downturn in the economy.
D) The swing from budget surpluses in the late 1990s to budget deficits in the early 2000s resulted exclusively from deep tax cuts by the Bush administration.
Answer: A

73. The immediate primary cause of the swing from Federal budget surpluses between 1998 and 2001 to a budget deficit in 2002 was:
A) the tax cuts of 2001.  
B) spending increases relating to the war in Afghanistan.  
C) the recession of 2001.  
D) the acceleration of inflation in 2001 and 2002.
Answer: C

74. Which of the following did not contributed to the large Federal budget deficits in 2002 and 2003?
A) spending on the wars in Afghanistan and Iraq.  
B) low interest rates.  
C) Federal tax cuts.  
D) the recession of 2001 and its aftermath.
Answer: B

Last Word Questions

75. (Last Word) The Social Security program (excluding Medicare) in the United States is projected to:
A) grow from 4.4 percent of GDP today to 6.5 percent of GDP in 2035.  
B) grow from 1.0 percent of GDP today to 4.4 percent of GDP in 2035.  
C) decline from 4.4 percent of GDP today to 1.0 percent in 2035.  
D) stay relatively constant at 3 percent of GDP into the future.
Answer: A

76. (Last Word) In the past few years, the Social Security trust fund in the United States has been:
A) drawn down to cover payouts that currently exceed payroll tax revenues.  
B) built up in anticipation of payroll revenue shortfalls beginning in 2018.  
C) draw down to eliminate unnecessarily large surpluses in the fund.  
D) built up because of greater than expected immigration to the United States.
Answer: B
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77. (Last Word) The Social Security program (excluding Medicare) in the United States is expected to use up the monies in the Social Security trust fund in:
   Answer: C

78. (Last Word) The Social Security program in the United States faces a long-term funding crisis because:
   A) the Social Security trust fund was exhausted in 2002.
   B) the number of retirees receiving benefits is rising more rapidly than the number of workers paying payroll taxes.
   C) recent tax cuts have reduced payroll tax revenues.
   D) the war on terrorism has drained funds away from Social Security.
   Answer: B

True/False Questions

79. If government was required by law to balance its budget annually, it would be obligated to increase its spending during a recession.
   Answer: False

80. Financing wartime expenditures by increasing internally held public debt permits a nation to defer a part of the economic cost of war.
   Answer: False

   Answer: False

82. It is more meaningful economically to measure the public debt relative to the GDP than to measure it in absolute terms.
   Answer: True

83. The United States has experienced budget surpluses in recent years.
   Answer: True

84. The functional finance philosophy says that the Federal government should balance its budget over the course of the business cycle.
   Answer: False
85. The public debt is the accumulation of all deficits and surpluses that have occurred through time. 
    Answer: True

86. The public debt is held as Treasury bills, Treasury notes, Treasury bonds, and U.S. savings bonds. 
    Answer: True

    Answer: True

88. The crowding-out effect of the public debt may be dampened if the investment-demand curve is shifting to the right. 
    Answer: True

89. The Deficit Reduction Act of 1993 limits the public debt to 100 percent of the GDP. 
    Answer: False