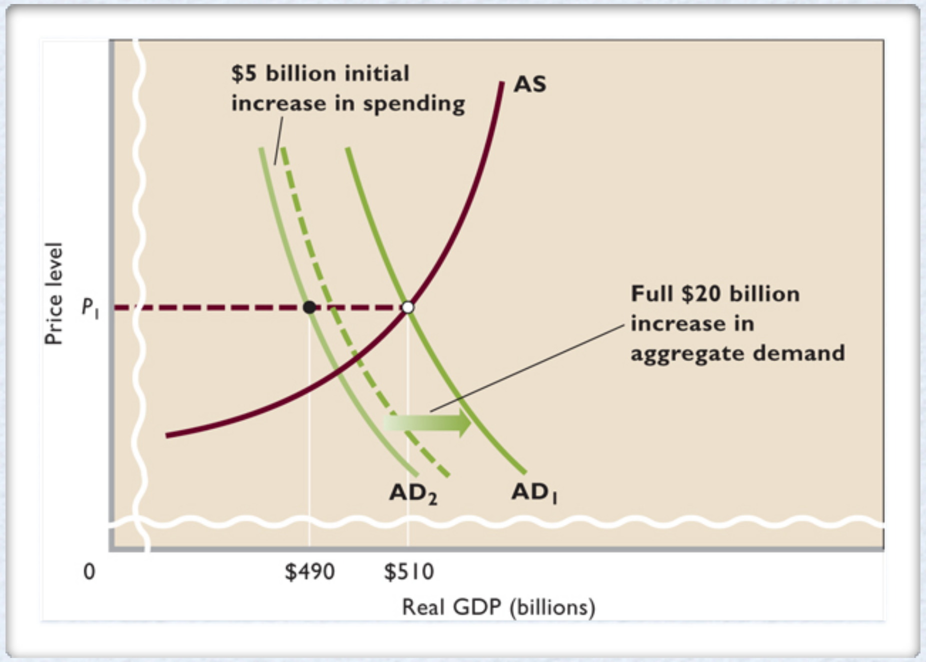
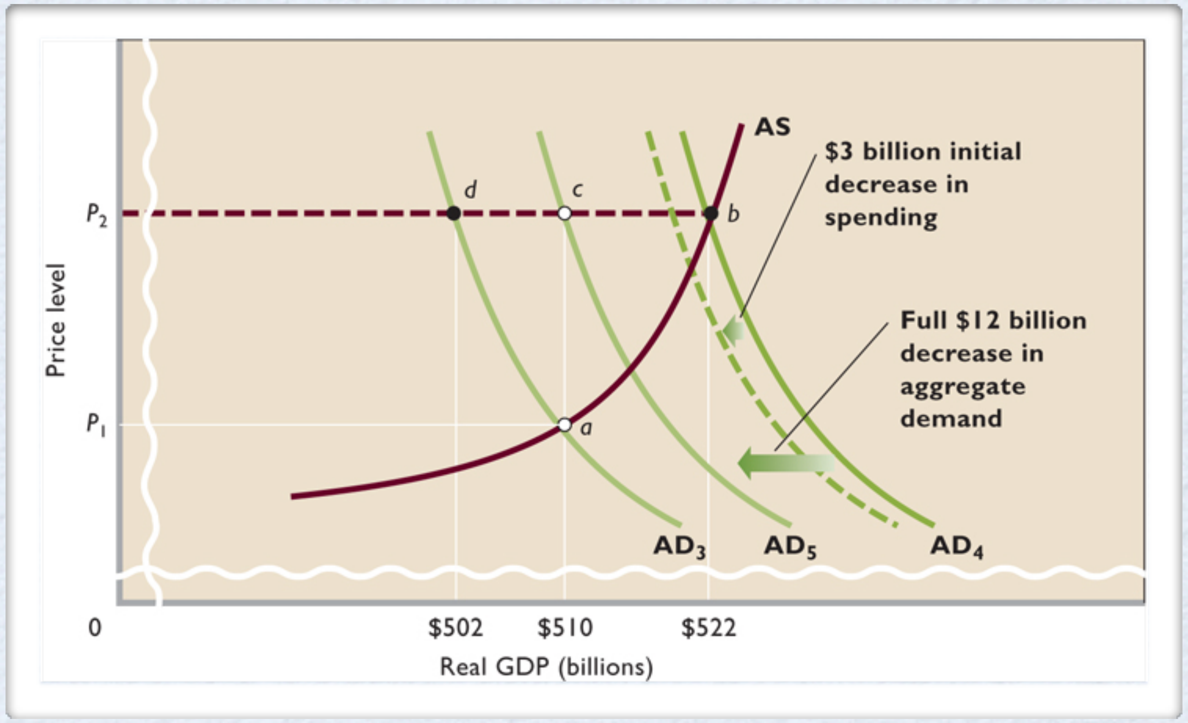
CHAPTER 15

Expansionary Fiscal Policy

- Expansionary fiscal policy
  1. Increased government spending
  2. Decreased taxes
  3. Combined government spending increases and tax reductions
- Contractionary fiscal policy
  1. Decreased government spending
  2. Increased taxes
  3. Combined government spending decreases and increased taxes





The Multiplier Effect

The relationship between changes in spending and changes in real GDP

- More spending results in a higher GDP
- A change in spending, changes output by more than the initial change in spending - the result is called **the multiplier effect**
- **The multiplier** determines how much larger the change in the GDP will be
- **Multiplier** = $\dfrac{\text{change in real GDP}}{\text{initial change in spending}}$
- **Change in GDP = multiplier * initial change in spending ➠ m * ΔC = ΔGDP**
  ΔI = +$30B, m = 3 ➠ ΔGDP = ? ➠ ΔGDP = +$90B

The Multiplier Effect

The multiplier and the marginal propensities

- **MPC** $= \Delta C \; / \; \Delta Y$
- **Multiplier** $= \dfrac{\mathbf{1}}{\mathbf{1 - MPC}}$
- Example: MPC $= 0.8$ ➠ m = ?
- If MPC $= 0.8$ ➠ $\dfrac{\mathbf{1}}{\mathbf{1 - MPC}}$
- $m = \dfrac{1}{1 - MPC}$ ➠ $\dfrac{1}{1 - 0.8}$ ➠ $1/0.2 = 5$

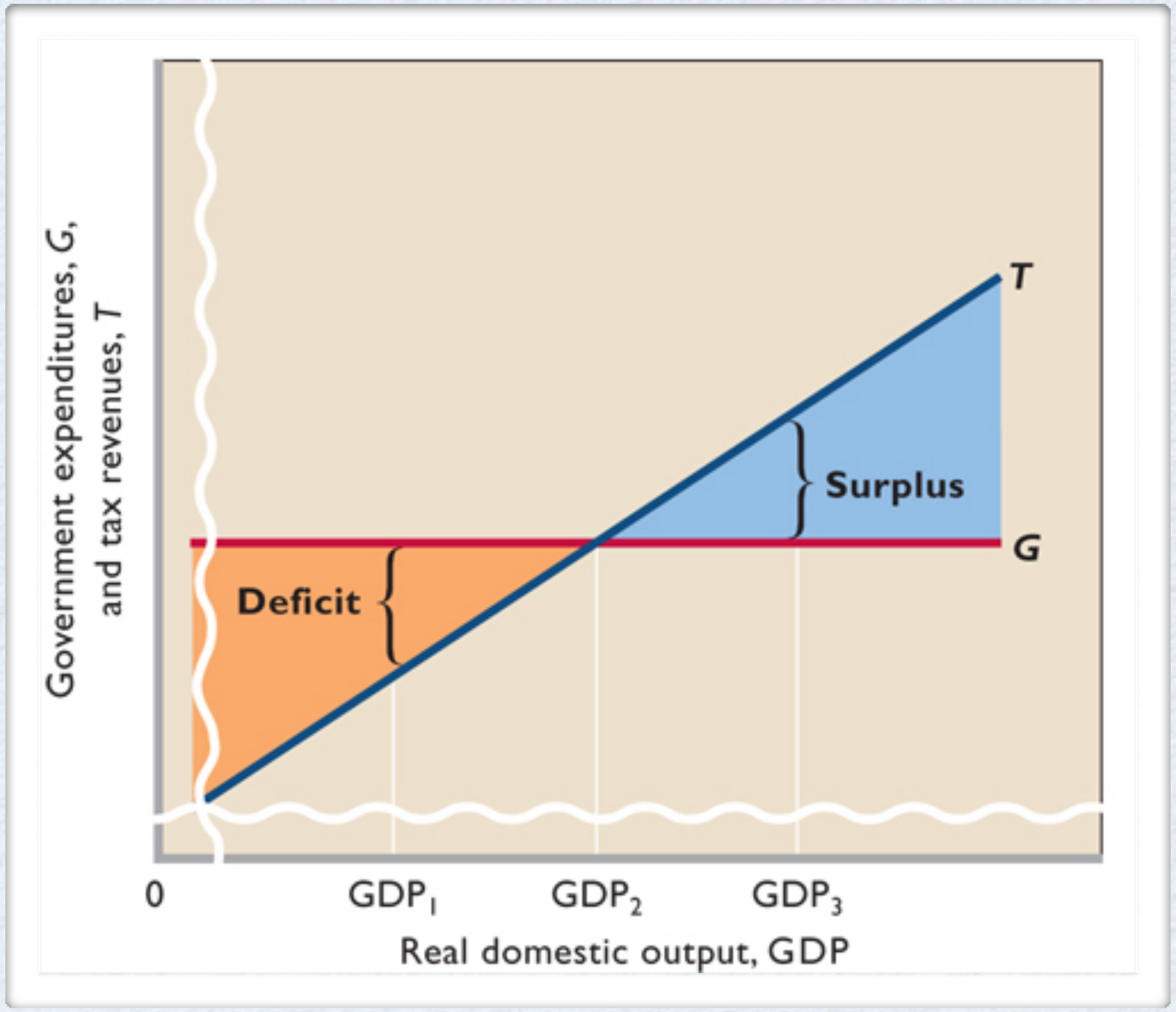
The Multiplier Effect

The tax multiplier

- If MPC = 0.5 ➠ $\frac{\mathbf{1}}{\mathbf{1 - MPC}}$
- $m = \frac{1}{1 - MPC} \Rightarrow \frac{1}{1 - 0.5} \Rightarrow 1/0.5 = 2$
- **Tax multiplier** = 1 - spending multiplier = 1 - 2 = *-1*
- ΔT * Tm = ΔAD = - $1 Trillion * *-1* = $1 Trillion
- ΔG * Sm = ΔAD = ΔG * 2 = $1 Trillion ➠ ΔG = $500 Billion

Built-In Stability

- Automatic or built-in stabilizers - tax revenue varies directly with GDP
- G is assumed to be independent of GDP



Problems, Criticisms, and Complications

- **Problems of timing**

  1. **Recognition lag** - the time between the beginning of recession or inflation and the certain awareness that it is actually happening

  2. **Administrative lag** - the time the need for fiscal action is recognized and the time action is taken

  3. **Operational lag** - the time fiscal action is taken and the time that action affects output, employment, or the price level

- **Crowding-out effect** - an expansionary fiscal policy may increase the interest rate and reduce investment spending, thereby weakening or canceling the stimulus of the expansionary policy