MODULE 31

31 Fiscal Policy and the Multiplier

Using the Multiplier to Estimate the Influence of Government Policy

- Fiscal policy has a **multiplier effect** on the economy.
- Fiscal policy can take the form of changes in taxes, transfers, and government spending.
- The multiplier on changes in government purchases is $\mathbf{1/(1 - \mathit{MPC})}$.

Multiplier Effects of Changes in Taxes and Government Transfers

- Assume the government cuts personal taxes $50 billion.
- There is no direct effect on AD by government purchases of goods and services; GDP goes up only because households spend some of that $50 billion.
- How much will they spend?
  - If *MPC* = 0.5, the first-round increase in consumer spending will be $25 billion (0.5 × $50 billion = $25 billion).
  - There will be a series of subsequent rounds in which real GDP, disposable income, and consumer spending rise further.

Multiplier Effects of Changes in Government Transfers and Taxes

TABLE 31-1

Hypothetical Effects of a Fiscal Policy with Multiplier of 2

Effect on real GDP	$50 billion rise in government purchases of goods and services	$50 billion rise in government transfer payments
First round	$50 billion	$25 billion
Second round	$25 billion	$12.5 billion
Third round	$12.5 billion	$6.25 billion
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Eventual effect	$100 billion	$50 billion

Multiplier Effects of Changes in Government Transfers and Taxes

- The multiplier on changes in taxes or transfers, ***MPC*/(1 − *MPC*)**, because part of any change in taxes or transfers is absorbed by savings.

- The results from changes in taxes are complicated because governments rarely impose lump-sum taxes.

- ***Changes in government purchases have a more powerful effect on the economy than equal-sized changes in taxes or transfers.***

How Taxes Affect the Multiplier

- Rules governing taxes and some transfers act as **automatic stabilizers,** reducing the size of the multiplier and automatically reducing the size of fluctuations in the business cycle.

- In contrast, **discretionary fiscal policy** arises from deliberate actions by policy makers.

Economics in Action

Multipliers and the Obama Stimulus

- The American Recovery and Reinvestment Act was the largest discretionary fiscal expansion in U.S. history -- $787 billion.
- Economists assumed that the government spending and tax relief would yield an overall multiplier for the stimulus of 1.4, or add approximately 1.8 percentage points to real GDP.
- This didn’t happen. The problem was that financial crises tend to produce very deep, prolonged slumps.