FISCAL POLICY: THE MULTIPLIER EFFECT

Rush
December 2014

COMPELLING QUESTION

- How does government fiscal policy affect spending throughout the economy?

OBJECTIVES

- Students will be able to:
- Define expansionary and contractionary fiscal policy
- Explain how multipliers increase the impact of fiscal policy
- Explain how crowding out can diminish the impact of fiscal policy
- Analyze conditions that make fiscal policy more effective in influencing the economy

TODAY

- You are going to participate in a series of short acts in a play about fiscal policy. (Fiscal policy is a government's course of action to influence economic performance through taxation or government spending.)
- In this play, you, the actors, are going to write your own lines.

HOW THIS WILL WORK

- Group 1, nine students.
- Groups 2-5, five students.
- Instructions: In your group, choose parts and write a few lines for your role on notecards or paper. To perform the play, line up next to each other in order and deliver your lines to the person next in line.
- Have fun with it.
- Take about 10 minutes to prepare.

FISCAL POLICY ACTS

Example:

Your role says: "Unemployed software engineer. Happy to be hired again. Celebrates by remodeling his kitchen."

You need to write lines:

"I am a software engineer with a degree from the University of Michigan. It was tough finding a job this past year, but then Google offered me a great position, earning six figures. I'm going to spend some of my income to remodel my kitchen, which is from the '70s."

AUDIENCE RESPONSIBILITIES

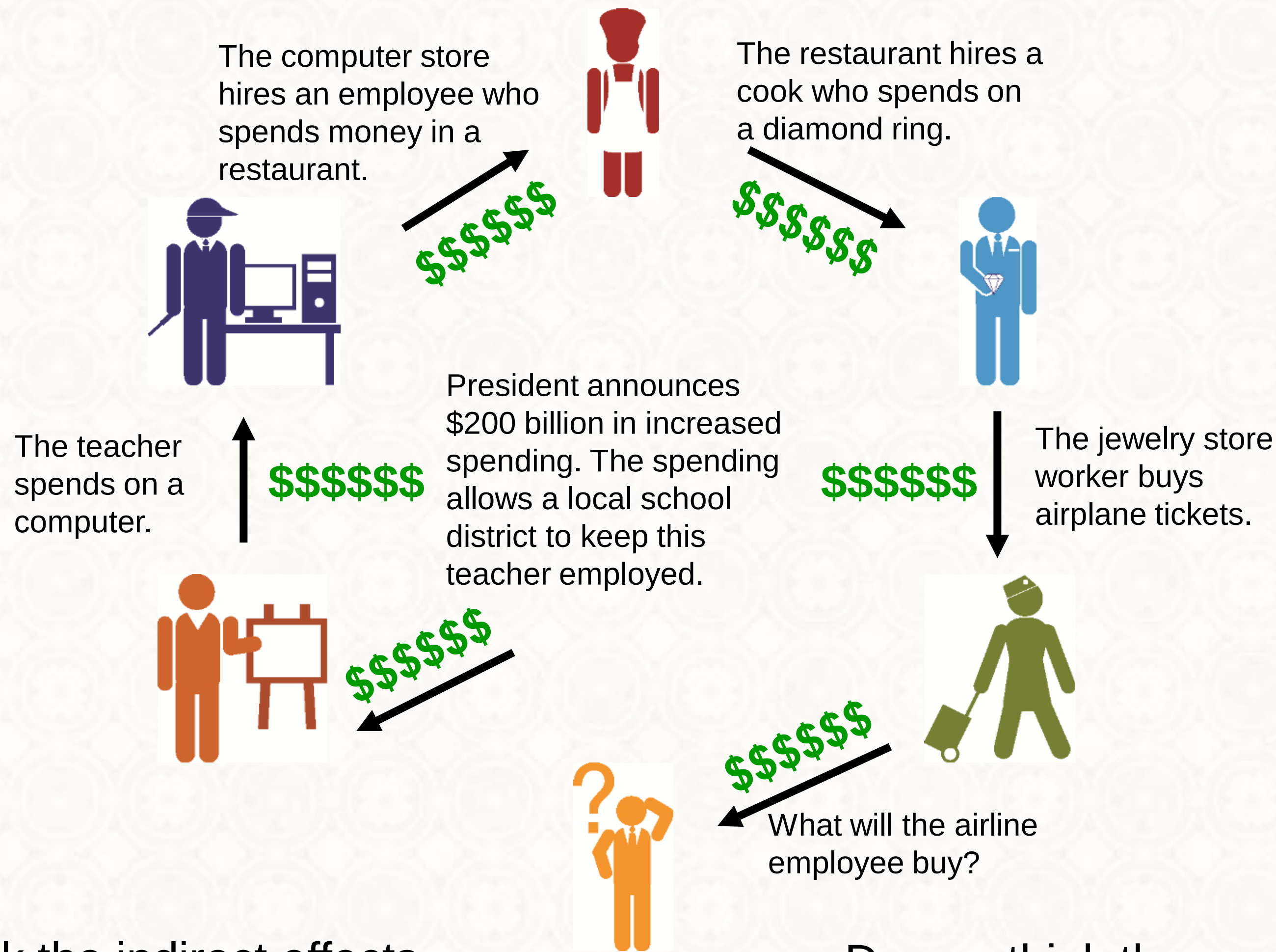
- In writing, for each act:
- Describe the problem.
- Describe the president's policy solution.
- Describe the impact on spending and GDP.
- Focus on what is DIFFERENT about each act.

PUT ON A SHOW!

ACT 1

- What happened?
- The economy is in a recession. The president announced increased spending of $200 billion; some of it went to the teacher. The teacher bought a computer, which helped the computer store hire someone, and so on …

ACT 1: FISCAL POLICY



Do you think the indirect effects will continue?

Do you think the government spending set in motion other chain reactions like this one?

ACT 1: FISCAL POLICY

Multiplier effect

The idea that an increase in spending by consumers, businesses, or government can cause larger changes in economic production. This occurs because spending becomes someone else's income, which then generates more spending. The multiplier also works in reverse when spending decreases.

ACT 2: FISCAL POLICY

- What was different in the second act?
- This time, the economy is in better shape, but not in a time of robust expansion. Also, interest rates are rising, and banks don’t have as much money to lend. This was not an issue in the first act because the recession was so severe.

ACT 2: FISCAL POLICY

- Is the chain reaction the same in this act?
- The teacher's spending would probably still help the computer store and so forth.
- What happens to the construction company?
- The construction company can't borrow money to invest, so it doesn't buy equipment.
- This is called the crowding-out effect.

ACT 2: FISCAL POLICY

Crowding-out effect

An increase in government spending funded by government borrowing can increase interest rates that, in turn, can decrease or *crowd out* private investment.

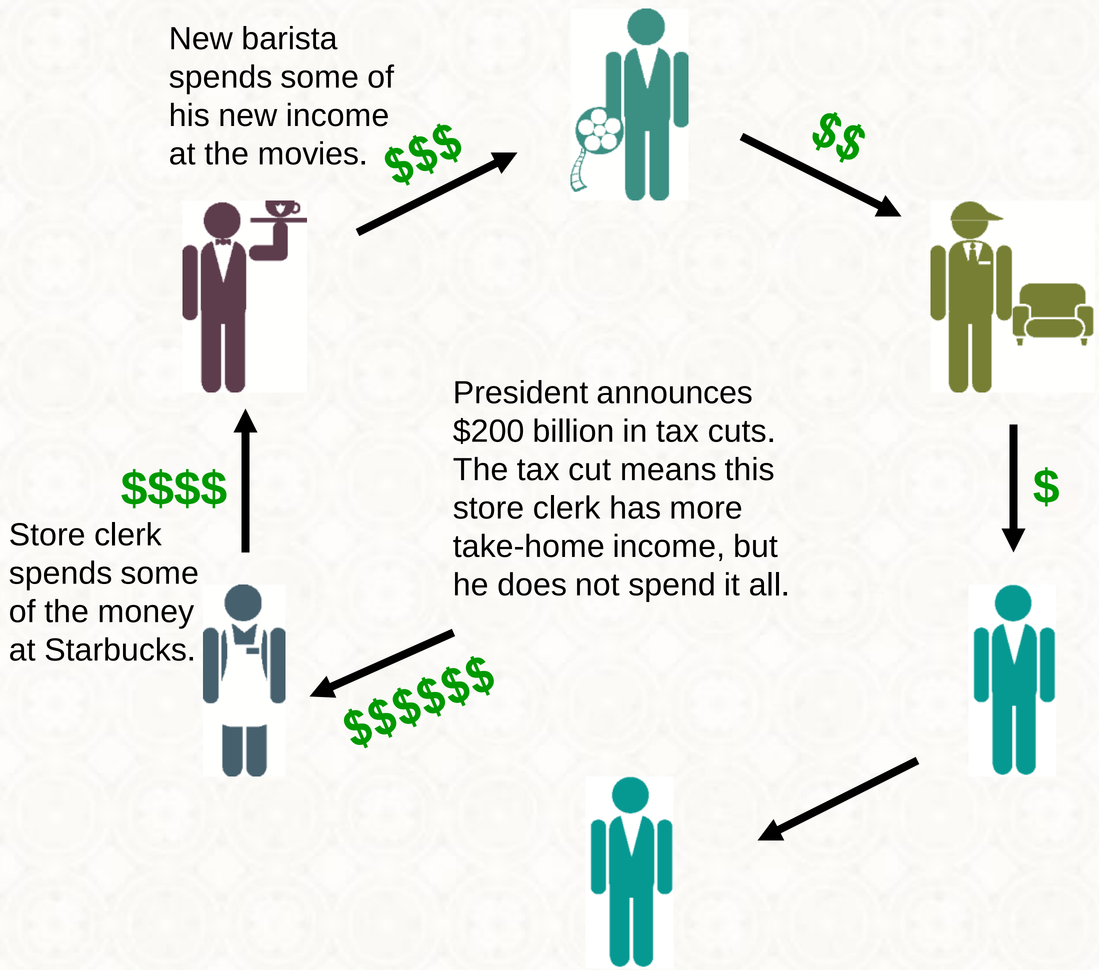
If crowding out occurs, what happens to the multiplier effect and the change in GDP?

The fiscal policy won't have as large an effect. GDP will change by a smaller amount or not at all.

ACT 3: FISCAL POLICY

- What happened?
- The economy is in deep recession.
  The president announced permanent tax cuts of $200 billion, targeting lower- and middle-income households.
- How was the impact of the tax cut different than the increase in government spending?
- The store clerk and barista spend some – but not all – of their additional income.

ACT 3: FISCAL POLICY

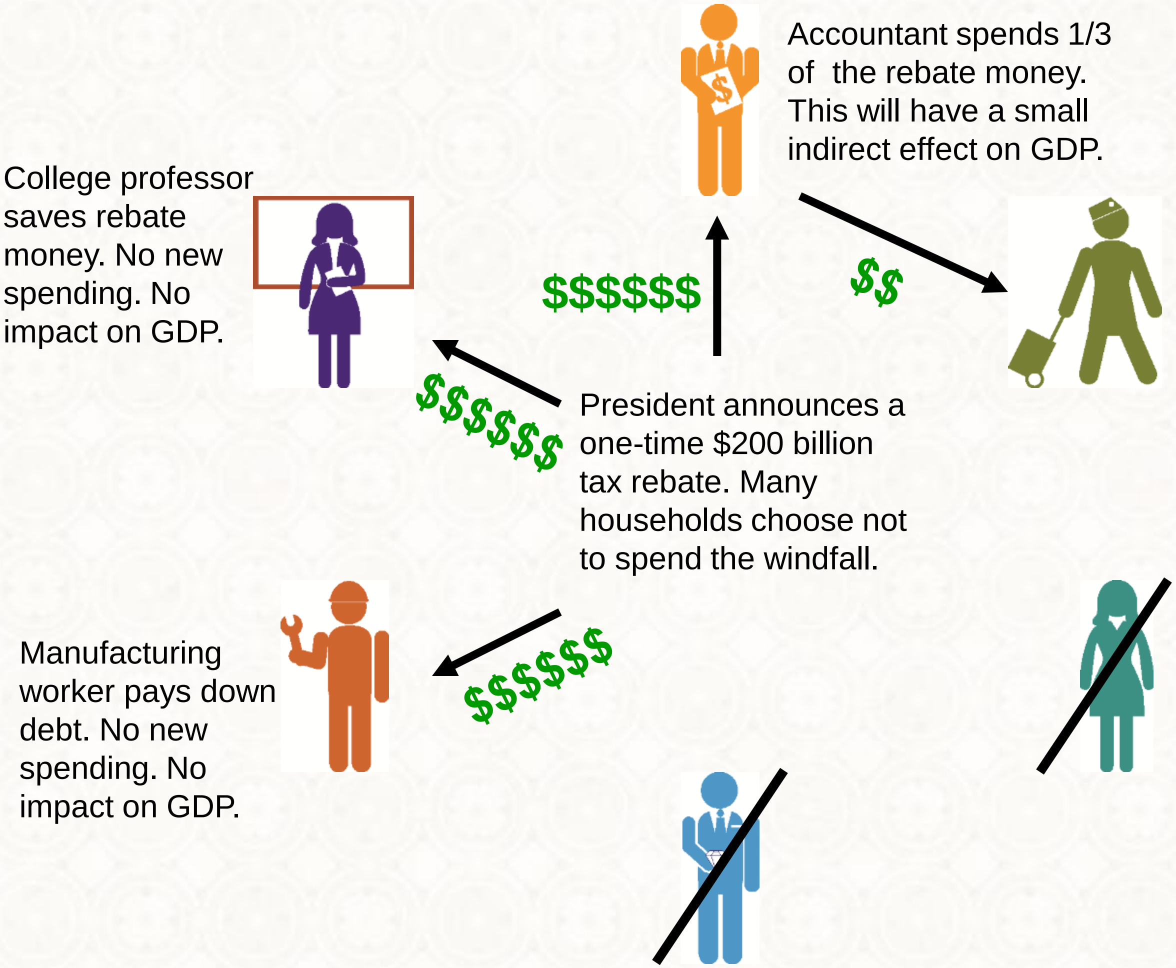


Unlike increased government spending, a tax cut does not have a direct effect. A tax cut increases GDP only indirectly, if the individuals who receive more income decide to spend it.

ACT 4: FISCAL POLICY

- What happened?
- The economy is in a deep recession. This time, the president announced a one-time $200 billion tax rebate.
- Did the consumers spend their windfall?
- For the most part, no. Most of the money was saved or used to pay down debts.
- Will this have as significant an effect as the policies in Act 1 and Act 3?
- No, not if people don’t spend the money.

ACT 4: FISCAL POLICY



Note the smaller effect. Research has demonstrated that households are much less likely to spend a one-time tax rebate than money received from a permanent tax cut.

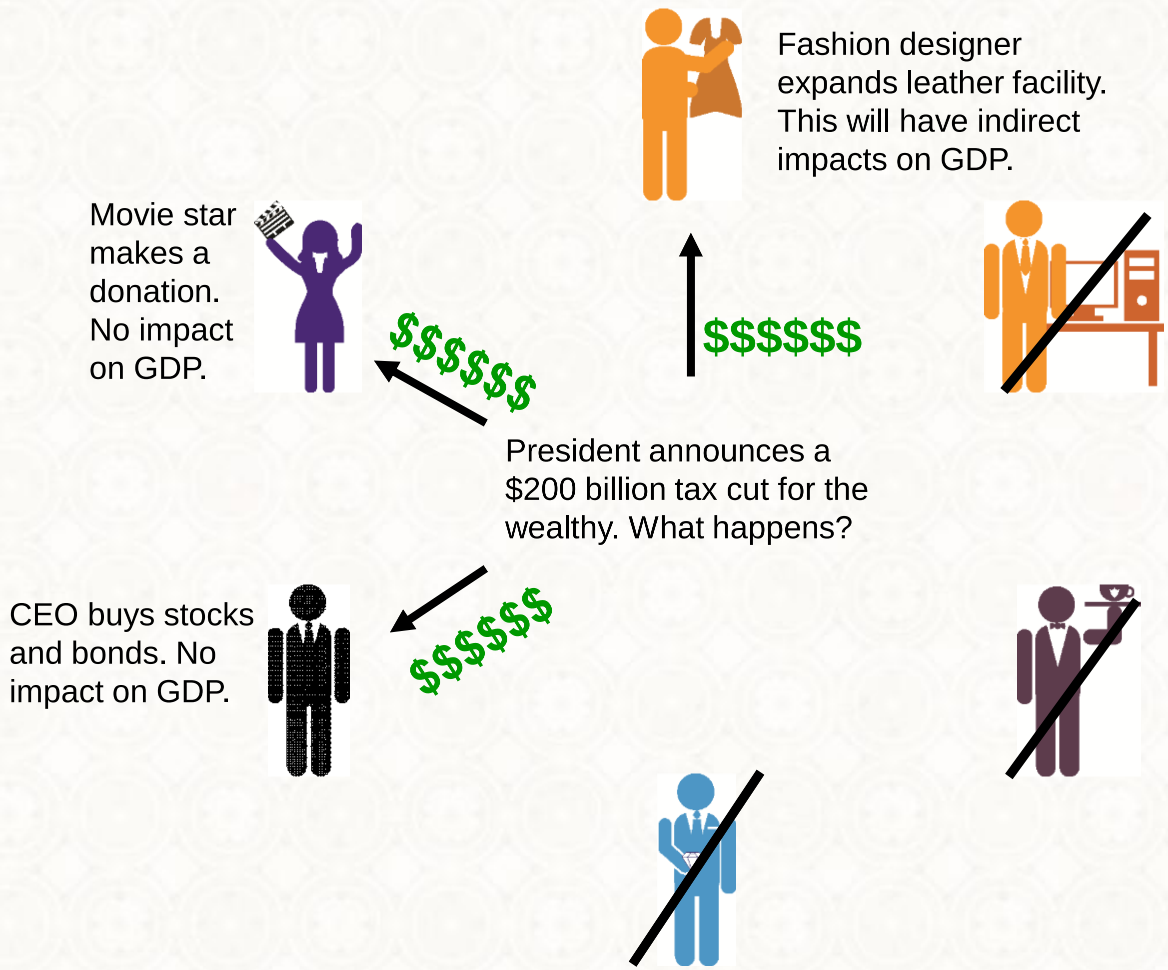
ACT 5: FISCAL POLICY

- What happened?
- The economy is in a deep recession. The president has announced a $200 billion tax cut that will impact only the wealthiest Americans.
- What did the wealthy households do with their additional income?
- One bought stocks and bonds. One made a donation that went outside the country. One used the money instead of borrowing to expand a business.

ACT 5: FISCAL POLICY

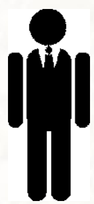
- What direct effects did you note?
- None.
- What indirect effects?
- The business expansion would have an indirect effect, but this would have happened anyway.

ACT 5: FISCAL POLICY

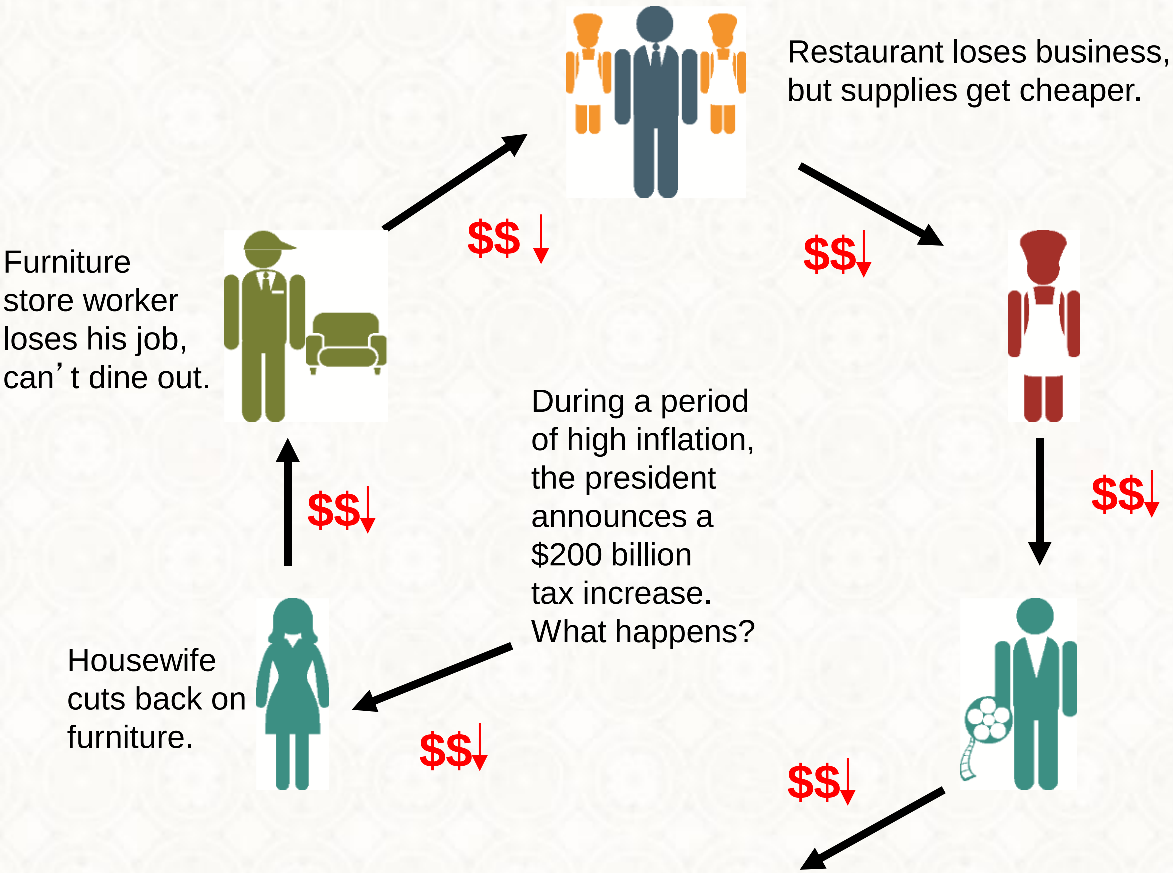


ACT 6: FISCAL POLICY

During a period of high inflation, the president announces a $200 billion tax increase. What happens?



ACT 6: FISCAL POLICY



As each individual loses income and cuts back spending, there is a chain reaction.

FISCAL POLICY

Expansionary fiscal policy

An increase in government spending and/or a decrease in taxes designed to increase aggregate demand in the economy, thus increasing real output and decreasing unemployment.

Contractionary fiscal policy

A decrease in government spending and/or an increase in taxes designed to decrease aggregate demand in the economy and control inflation.

EXPANSIONARY FISCAL POLICY

- Which acts demonstrated expansionary fiscal policy?
- Strategies?