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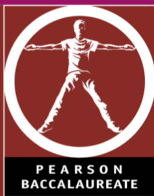

Economics

Worksheet 17.1

How Big is the US Government Spending Multiplier?

What is the goal of fiscal stimulus during a recession? Is it simply to increase nation's total income by a certain amount determined by how much a government increases its own spending by? If this were the case, then an $800 billion stimulus package, like the one undertaken in 2009 in the US, would lead to a total increase in national income of, well, exactly $800 billion.

While such an outcome is possible, it is not the desired outcome of any policymaker or economist who advocates the use of Keynesian stimulus during recessions. Keynesians expect that an initial increase in government spending (or a decrease in taxes) will result in households and firms increasing their own consumption and investment, meaning a greater overall increase in spending than the initial change undertaken by the government. The initial change in spending ultimately gets *multiplied* through further rounds of spending. The total change in national income resulting from an initial change in government spending or taxes depends on the size of the *spending multiplier*. Now, this is where things get tricky! From *The Economist* read the third paragraph from this article.

The above scenario, where an economy is operating below full-employment and government spending puts the nation's idle resources to work, creates new income and further increases private spending, is precisely what the US government hoped would happen following the 2009 fiscal stimulus package. A multiplier of above one means the $800 billion would ultimately increase America's national income by something greater than $800 billion! Read paragraphs four and five from the article linked to above.

Herein lies the controversy about the effectiveness of deficit-financed fiscal stimulus. Supply-side economists argue that expansionary fiscal policy financed by government borrowing will drive up interest rates to private borrowers, thereby 'crowding-out' private investment, off-setting any expansion in output achieved through government spending. In the Keynesian model, however, it is precisely because there is little or no private investment that government borrowing and spending will *not* lead to crowding-out, rather could actually increase investors' willingness to spend on new capital, actually '*crowding-in'* private investment.

The debate continues between the Keynesians and the supply-siders carries on. Interestingly, even years after a fiscal stimulus is undertaken, it will still be impossible to determine how large the fiscal multiplier was, since economists in the future will find it nearly impossible to isolate the impact of a particular fiscal policy on a country's long-run economic growth rate.

Questions:

1. Why do tax cuts for the rich tend to have a smaller multiplier effect than tax cuts for lower income households?

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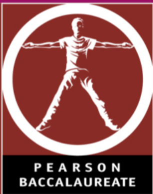

2. How can government borrowing drive up interest rates, and why is this a concern to policy makers deciding on the size of a fiscal stimulus package?
3. What risk does deficit financed fiscal policy pose to the level of confidence and expectations among domestic households and firms? Why does greater national debt threaten to slow the growth prospects of an economy stuck in recession?

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