Expansionary Policy

by Sophia

WHAT'S COVERED

This tutorial will cover expansionary policy, focusing on fiscal policy and the expansionary tools available to use when the country is in a recession.

Our discussion breaks down as follows:

1. Tools of Fiscal Policy: Expansionary Policy
    a. Government Spending
    b. Taxation
2. Consumption Multiplier
3. Taxation Multiplier
4. Success of Fiscal Policy

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1. Tools of Fiscal Policy: Expansionary Policy

There are two tools of fiscal policy:

1. Government spending
2. Taxation

Fiscal policy focuses on the policies in these two different areas. The government can then use these two tools to stabilize our economy's movement through business cycles.

Expansionary policy, as your key term, is defined as either monetary or fiscal policy that is enacted to stimulate economic growth, as measured by the GDP growth rate.

In this tutorial, we will focus on fiscal policy versus monetary policy.

TERM TO KNOW

Expansionary Policy

Either monetary or fiscal policy that is enacted to stimulate economic growth (as measured by the GDP growth rate)

1a. Government Spending

Let's start with government spending. We know that our government spends a lot of money in the economy in many areas, such as:

- National defense
- Education and healthcare
- Welfare programs
- Infrastructure

If the government wants to stimulate our economy--perhaps because it is in a recession--one of the things they can do is spend more money in any of these areas in order to create jobs or give people money to spend.

If we look at our expenditure approach to calculating GDP, considering only domestic spending, Y is our economic activity, comprised of the following components:

FORMULA TO KNOW

Expenditure (Domestic)

$$Y = C + I + G$$
$$where:$$
$$C = Consumer\ purchases$$
$$I = Investment\ in\ capital\ (generally\ by\ businesses)$$
$$G = Government\ purchases$$

If the government increases spending (G), the hope is that this will also encourage greater consumer and business spending (C & I).

Generally, the government intervenes when consumers are not spending, and neither are businesses because the economy is slow. Therefore, if the government starts spending, hopefully, we can pump money in and get consumers and businesses spending again.

The problem is, if they increase taxes in order to pay for that increased government spending, this will be counterproductive.

THINK ABOUT IT

If the government creates more programs and tries to give you more money to spend, but at the same time they increase your taxes, now they are taking that money away from you. Hence, it is completely counterproductive.

So, without increasing taxes, what does our government have to do? Well, they have to borrow money, and the way our government borrows money is by selling Treasury securities to finance the increased government spending needed to stimulate the economy.

Therefore, they take on debt. Keep in mind, though, when they repay the debt, tax revenue will need to be used.

1b. Taxation

The second tool of the government is taxation. Federal, state, and local governments all collect taxes from citizens in order to fund programs.
Another way to stimulate the economy, then, would be to cut taxes to give people more money to spend.

So, by either increasing government spending or cutting taxes, the government is attempting to get people to spend money. They are injecting money into the economy.

Therefore, expansionary fiscal policy is when government spending is greater than the tax revenue they are taking in, by either increasing their spending, cutting tax revenue, or both.

BIG IDEA

Expansionary fiscal policy: Government spending > Tax revenue.

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2. Consumption Multiplier

So, if the government increases spending, the intent is that it has a multiplied effect by encouraging greater consumer and business spending, referring to the C and the I.

EXAMPLE Suppose you get hired as a government employee, as a result of increased spending. Now you have money that you did not have before, to go out and spend in restaurants, on vacations, etc. In turn, those places of business will now have more money to pay their workers, and those workers will, in turn, have more money to spend elsewhere.

How much will the multiplied effect be? Well, there is actually a way to go about calculating this.

It really depends on how much of that new income you are going to spend versus save. If you save it all, you will not create a multiplied effect on the economy. If that money is simply stored in the bank, it is not creating other jobs and becoming part of other people's income, to then be spent in the economy.

So, the more you spend, the greater the multiplied effect there will be in the economy.

We can find the potential multiplied effect by calculating a consumption multiplier, using the following formula:

FORMULA TO KNOW

Consumption Multiplier

$$\text{Consumption Multiplier} = \frac{1}{1 - MPC}$$

where:

$$MPC = \text{Consumers' Marginal Propensity to Consume}$$

Now, MPC is our consumers' marginal propensity to consume. It is the percentage of all income that is being *spent* in the economy.

> **IN CONTEXT**
>
> Suppose the government wants to increase GDP, so they spend $10 billion on new programs. The marginal propensity to consume is 0.75, or 75%. What overall effect will this have on the economy? Will it stop at $10 billion?
>
> The MPC of 0.75 tells us that economy-wide, people will spend 75% of the additional income they receive. To put in individual terms, if you make an additional $100 on your next paycheck, your personal MPC of 0.75 indicates that you will spend $75 of it and save $25.
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> In this case, though, we are looking at the overall economy, so let's calculate our multiplier.
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> *Multiplier = 1 / (1 - 0.75)*
> *Multiplier = 1 / 0.25 = 4*
>
> Therefore, if the government injects $10 billion into the economy by increasing spending, this could, in theory, generate an additional $40 billion in economic activity, because we multiply it times our multiplier.
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> *$10 billion x 4 = $40 billion*

3. Taxation Multiplier

Now, suppose the government wants to increase GDP through taxes, by cutting taxes by $10 billion, for instance. In this case, we have to look at the impact this will have on consumption first, in order to find our multiplied effect.

It will increase our consumption by the MPC times the amount of the tax benefit:

0.75 x $10 billion = $7.5 billion increase in consumption

Next, we take that increase in consumption and multiply it by our multiplier of 4:

$7.5 billion x 4 (multiplier) = $30 billion

We can see that this has the potential to increase economic activity by $30 billion as a result of the $10 billion tax cut, which is actually a multiplier of 3 if you think about it that way.

4. Success of Fiscal Policy

Now, it is important to keep in mind why economics is considered a social science. It is a social science because we rely on how people react and behave.

These policies might make sense in theory, but we must understand how people are going to react and behave when these policies are implemented.

> EXAMPLE For example, a massive government spending campaign will do absolutely nothing to get us out of a recession if consumer confidence is too low. People will merely save any money versus spending it, and the result will simply be more government debt.

Therefore, when any policy is put in place, it generally takes some time for it to improve the economy; it does not happen overnight. This amount of time is called a "lag" in economics, and the longer it takes to see the improvement, the more people can lose confidence.

Ironically, it is exactly that confidence that is needed to help the policy work, because as soon as consumers and businesses are confident, they start spending money.

This is why it is important for people to be educated in this field. It is also important that our media communicates these policies to us in a fair and accurate manner.

SUMMARY

Today we learned how the **tools of fiscal policy--government spending** and **taxation** could be used by the government to implement **expansionary policy** during a recession. We learned that the government could increase spending and/or reduce taxes to give us more money to spend. In either case, through the **consumption multiplier** or **taxation multiplier**, expansionary policy can have a multiplied effect. Lastly, we learned how the **success of fiscal policy** really depends upon consumer confidence and understanding.

Source: Adapted from Sophia instructor Kate Eskra.

TERMS TO KNOW

Expansionary Policy
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