Name \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ Date \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ MPC and MPS Module #16

In 1936 the British Economist, John Maynard Keynes, wrote “The General Theory of Employment, Interest and Money”. The world was in the midst of the Great Depression. He developed the concept of the Marginal Propensity to Consume (MPC). Keynes believed that the classical economic approach of letting an economy in recession fix itself was not working and putting the lives of people in peril. His approach was that the government should direct the economy, like an orchestra conductor or captain of a ship, and use government spending as a tool to help the economy grow and “steer” it out of the Great Depression.

To mathematically demonstrate his idea, he derived the spending multiplier formula. Keynes’ idea was that an increase in aggregate expenditures (overall national spending) would have an even larger impact on real GDP growth. This is called the multiplier effect. President Franklin D. Roosevelt (FDR) put much of Keynes’ ideas into action with his New Deal that was implemented during the 1930s. The impact of the New Deal alone will never be known due to World War Two, most modern economists today acknowledge that the premise of Keynesian Economics has some merit.

Below are a couple of tables for you to demonstrate that you understand the math that is foundational to Keynesian Economics. (Yd) is change in disposable income, ( C) is consumption, (S) is savings, MPC is marginal propensity to consume and MPS is marginal propensity to save. Remember MPC + MPS always equals 1.

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Yd | C | S | MPC | MPS | Equals |
| 1,000 | 900 |  |  |  |  |
| 2,000 | 1,700 |  |  |  |  |
| 4,000 | 3,200 |  |  |  |  |
| 10,000 | 7,500 |  |  |  |  |
| 20,000 | 14,000 |  |  |  |  |
| 50,000 | 30,000 |  |  |  |  |
| 100,000 | 55,000 |  |  |  |  |
| 250,000 | 125,000 |  |  |  |  |

Would John Maynard Keynes be pleased with these numbers? EXPLAIN

The next step in the Keynesian Economic approach is to show how an increase in spending may lead to an even larger increase in gross domestic product. According to the spending multiplier formula, the total aggregate output of the nation will increase by the change in overall spending by the multiplier. The multiplier formula is 1/(1-MPC). Now it is to be understood that (1-MPC) = MPS, but Keynesians focus on the impact of spending on the overall economy. Therefore, the emphasis must be placed on MPC. When the math is complete RGDP is increased by the multiplier formula x additional dollars spent. Complete the table below and then answer the following questions.

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| Yd | C | S | MPC | MPS | Multiplier | Change in RGDP |
| 100,000 | 50,000 |  |  |  |  |  |
| 100,000 | 60,000 |  |  |  |  |  |
| 100,000 | 75,000 |  |  |  |  |  |
| 100,000 | 80,000 |  |  |  |  |  |
| 100,000 | 90,000 |  |  |  |  |  |

1. Would the multiplier be larger or smaller if people spent 99% of all of their additional income rather than the numbers provided in the above table?
2. What would happen to the multiplier if people chose to save a majority of their additional income?
3. Why would a Keynesian believe a paradox exists if people choose to save a majority of their income instead of spending it?
4. What is happening to RGDP growth as the spending multiplier increases?
5. What are two possible negative effects of Keynesian economic theory?