Module Overview

Module Overview: The Keynesian Model and Fiscal Policy

In macroeconomics, the basic Keynesian model goes by many names. Some economists refer to it as the "multiplier model" while others call it the aggregate production-aggregate expenditures model. Regardless of which name it goes by, it is one of the most important analytical tools in macroeconomics.

During this module, we illustrate the basic Keynesian model and show you how the development and application of the basic Keynesian model gave birth to fiscal policy, where fiscal policy involves the use of government expenditure or tax changes to expand or contract an economy.

Key Questions:

1. What is the most important assumption underlying the Keynesian model?
2. Illustrate the basic Keynesian model and a recessionary gap.
3. What is a "leakage"? What is the most important leakage in the government sector?
4. Define aggregate production. How is it represented in the Keynesian model?
5. Define aggregate expenditures.
6. What is the difference between autonomous consumption and induced consumption in the Keynesian model?
7. Define the marginal propensity to consume and the marginal propensity to save.
8. What is the slope of the aggregate expenditures curve?
9. Why is the aggregate expenditures curve flatter than the 45-degree line in the Keynesian model?
10. What are the determinants of investment?
11. Discuss the role of transfer payments in the macroeconomy.
12. What is a "closed economy"?
13. Define the Keynesian expenditure multiplier. Why is it greater than 1?
14. How is the Keynesian multiplier calculated?
15. Suppose the United States permanently increases defense spending by $100 billion in response to a threat to the oil fields in the Middle East. What will be the effect of this increase in government spending on the gross domestic product, assuming the marginal propensity to consume is two-thirds?
16. How much should taxes be cut to close a $100 billion recessionary gap, assuming that the marginal propensity to consume is .8?
17. Suppose the economy is in equilibrium at $960 billion. But this is $60 billion above the full employment output of $900 billion. What do we call this situation? How would you use fiscal policy to address it, assuming a marginal propensity to consume of .75?
18. Is it more preferable to increase government spending or cut taxes to eliminate recessionary gaps?
19. Use the Keynesian model to explain the Great Depression.
20. What is the paradox of thrift?

21. What is crowding out?
22. Illustrate the relationship between the Keynesian and the Aggregate SupplyAggregate Demand models.