

Question #72242: Analyse the impact of a cut in government spending of 10 billion pounds if the multiplier is 1.5 rather than 0.5

Answer

The key to the answer of this question is to analyse two separate cases and compare each other.

The basis for the mentioned two cases are Keynesian Cross¹ and the following formula:

$$\frac{\Delta Y}{\Delta G} = m_g = \frac{1}{1 - b}$$
²

where

ΔY – is the change of equilibrium GDP,

ΔG – is the change of the government spending,

m_g – is the multiplier of government spending,

b – is marginal propensity to consume (MPC).

From the conditions we can be informed that $\Delta G = \text{£}10\text{bln}$. For the first case $m_g = 0.5$ and for the second one $m_g = 1.5$. So, for the first case the cut of $\text{£}10\text{bln}$ of the government spending will cut the equilibrium GDP for $\text{£} 5\text{bln}$ ($\Delta Y = 0.5 * \text{£}10\text{bln} = \text{£} 5\text{bln}$). On the other hand, for the second case this kind of decrease in the government spending level will bring the decline of the equilibrium GDP for $\text{£} 15\text{bln}$ ($\Delta Y = 1.5 * \text{£}10\text{bln} = \text{£} 15\text{bln}$). By comparing these to results, we can conclude that if multiplier is equal to 1.5 the equilibrium GDP will decrease 3 times, so the decline in equilibrium level will be deeper than for the first case.

Answer provided by AssignmentExpert.com

¹ https://en.wikipedia.org/wiki/Keynesian_cross

² <https://xplained.com/958349/spending-multiplier>