Study on keynes income expenditure model economics essay

Income expenditure model proposed by British economist John Maynard Keynes analyses the relationship between GDP, Income and expenditure by individual and government as well. During 1930's, almost all the countries around world has faced severe recession, historically called as great depression. It was started in US in 1929 by huge decline in stock prices and spread to remaining part of the world. It was attributed to several reasons, main being indebtedness, deflation and high unemployment rates. Unemployment rates were all time high for almost a decade. Keynes has done extensive research on this depression and proposed that government spending at that point of time should increase to create new employment opportunities. But, government was not willing to follow these steps as spending during recession could worsen economy to much higher extent and government was more interested in decreasing interest rates, which almost reached record lowest levels. Further, most of the economists were in belief that markets recover itself without government interference. Hayek, famous economist of those days has also proposed in 1920's that markets should be left freely and government interference should be negligible. US and Britain government were least interested in following Keynes proposal as spending and tax cuts would push economy into more trouble. (Nelson, 2006)

Keynes' views on economy of country have been in and out of implementations several times, from the time he postulated them (Ovans, 2009). Though they proved effective, they were unable to bring economy into stable position due to slow implementation by than government. Keynes postulates came into full existence only after world war, when US government started following Keynes suggestions in improving US economy

and was succeeded to some extent (Ovans, 2009). 1946 employment act by federal government is mainly because if Keynes income expenditure model. This act was passed mainly to increase employment, thereby increasing production and purchasing power of the country.

This model proposes following facts that are accepted by almost all the economists. They include (Nelson 2006)

Individual expenditure is affected by government spending and taxation. This in turn affects countries GDP. An increase in government spending increases the income of individuals directly or indirectly, hence, the expenditure of individuals also increases, thereby increasing the GDP.

Decrease in taxation (tax cuts) also increases disposable income of individual’s and shows positive effect on GDP.

Due to above two facts, equilibrium level of GDP is consistent with aggregate expenditure.

We can come to conclusion that at equilibrium level of national income, GDP is equal to total aggregate expenditure (AE) of the country. It can be put down as,

GDP at equilibrium = AE at equilibrium

AE= C+ G+ I + X

Substituting, C= A + mpc (Y)

AE = A + mpc(Y) + G +I + X

Here, AE = aggregate expenditure, A= autonomous expenditure, X = net exports, I = investments, G = Government spending, mpc = Marginal propensity to consume and Y= Real GDP

Components

Though the model looks quite simple it is associated with different components. They include marginal propensity to consume, autonomous expenditure, aggregate expenditure, GDP, government spending and multipliers. These are main concepts to be considered, as part of income expenditure model. A change in one component can show immediate effect on other.

Autonomous expenditure (A): It is the consumption expenditure of the country independent of current income. This expenditure is constant and doesn’t change with change in real GDP. But change in autonomous expenditure can show effect on GDP. Autonomous expenditure is part of consumption function (C). This is mainly based on consumer’s needs. When the income is equal to zero, then also, country needs some basic needs that are to be fulfilled. These needs form autonomous expenditure.

Marginal propensity to consume (mpc): It is the extra expenditure on extra unit of income received. Technically, it is the proportion of increase in national income spent for expenditure. This is an important changing factor in deciding the real national income. It is usually represented by mpc. Slope in the graph represents marginal propensity to consume. If marginal propensity to consume increases GDP also increases.

Change in expenditure

mpc = ————————————-

Change in disposable income

Consumption function C, can be calculated from autonomous income and marginal propensity to consume.

C = A + mpc (Y)

Where, Y stands for real income at that point of time.

Aggregate expenditure (A): It is the total consumption expenditure. It usually considered sum of autonomous expenditure and induced expenditure. Induced expenditure is consumption expenditure that keeps on changing with real national income. In fact, this change in GDP is mainly due to induced expenditure.

Figure Keynes income expenditure model

Government spending (G): It is the expenditure that government incurs in providing extra works and releases money in to public. It involves subsidiaries given to increase demand, projects approved to increase employment, etc. According to Keynes, increase in government spending increases the money to be circulated. This money reaches public pockets and they increase their expenditure and investments. Thus, increasing the real national income of the country and improving the economy. For example, an increase in government spending by . 8 trillion, increases government spending to G*. Then, aggregate expenditure increases and graph can be shown as

Figure Change in government expenditure

Taxation: Taxation plays key role in changing the economy of country. Disposable income of individual's increases with tax cuts. This increases expenditures of individual and thus the GDP as well. An increase in the tax can reduce disposable income of individual's and shows negative impact on GDP (Franco and Richard, 1954).

National income at equilibrium (Ye): At Y1, expenditure is higher than national income. Government increases its spending by injection and improves real GDP to Ye. Ye represent equilibrium level of GDP. At this point, aggregate expenditure equals national income. This is the situation where withdrawals would be equal to injections in Keynes withdrawal-injection approach (Sloman and Garrat, 2010). When national income in higher than expenditure (Y2), government starts withdrawing money through net savings, net taxes and through expenditure on imports. Governments always try to maintain national income at equilibrium level, as higher income would make money stagnant in the country, higher supply can also lead to depletion of resources of the country and higher expenditure means high demand and lower supply. This can lead to exploitation of customer.

Keynesian multiplier: When government spending is increased by 10 million dollars, than national income increases by more than $10 million. This is due to snow balling effect. Keynes has used multiplier effect to give solution to this problem. He proposed two multipliers to nullify snow balling effect.

Government spending multiplier = 1/ 1-mpc

Tax cut multiplier = (1/ 1-mpc) – 1

Literature review

As mentioned earlier, Keynesian model has been in and out of system several times. Many economists have worked on it and kept on improving it. The main drawback of Keynesian model is that it is proposed mainly keeping in mind the economy of world during 1930's, where great depression hit the world severely (Blyth, 2009).

During recent recession in 2008-09, Keynes views on economy again came in light. Jack Oanh (2009), economics professor at Trinity College in his work " Keynes today", refined theory

As consumer spending is a part of income, while producer spending is a part of interest rates, variations in interests' rates or income of consumers will lead to change in gross domestic product/ national income. (Glasman, 2012)

After World War 2, American government has made lot of changes in economy. Especially during 1960's, the implementation of Keynes views was very successful during recession. Time magazine (1965) in its cover story titled ' We Are All Keynesians Now' Analysed that America is enjoying it's the best 5th consecutive year of the most prolonged, trusted and widely distributed economy in history of United states by following Keynes ideas."

In 1970's government again stopped being in Keynesian path because, following Keynesian to build long run in business cycle has become impossible. From then, every time Keynes models applied it is re-evaluated and applied to the economy. His ideas say that economy should not be self-

regulating. When economy is left freely at the time of recession, than it can enter death spiral in recession periods, which was the case of 2008-09. (Ovans 2009).

Criticism on Keynesian model

Some Economists still criticise this model by Keynes, especially Hayekians. Paul Krugman(2007), one of the followers of Keynes who has won Nobel Prize in economics field reported that “ If government involvement and spending can help improve employment and purchasing power, than why investments done in the past are not useful in nullifying the unemployment in present situation”. He calls them as bad investment on misguided ventures. He argues that if the government has spent on misguided ventures, pushing its people to the worst position than expected, why is there high unemployment rate? According to Keynes theory, employment rate should keep on increasing. But that’s not the scenario now and points out at Keynes postulates to be misguiding. (Economist, 2011)

Kevin Hassett (2011) complained that the total effect of Keynesian on GDP of the country is negative. According to Hassett, every stimulus like government spending, tax cuts, during depression has three but not two stages. When stimulus is given (Injection), GDP increases but gets economy to equilibrium and when stimulus is removed (withdrawals) GDP comes back to regular position. Now, the main effect takes place, public has to pay higher taxes or higher interest on ongoing borrowings. This causes further reduction in GDP. Thus, the effect of Keynes is negative in long run of economy. Some authors are in opinion that America doesn’t want to follow

Keynesian theory anymore and that's the reason that why Obama didn't apply them. (Taylor, 2012)

According to economists at Austrian School of Economics (2011), Government spending can disturb the market prices. These disturbed prices can show false impact on GDP and hence on economy of the country. The decisions taken due to these false factors can imbalance consumption and investment. These imbalances don't show any immediate effect of economy disruptions but its effect would be on large scale in near future. For example, sub-prime crisis in 2008-09 which were due to credit induced bad investment.

Conclusion

Keynes as already discussed has proposed this income expenditure model at the time of deep crisis prevailing round the world. His main concept was not being in stable economy for long run but moving in to stable or equilibrium economy through certain actions from unstable economy. Though they were lot of criticisms against this model, it proved itself to be successful in many scenarios of recessions. By making certain modifications we can implement them successfully to bring equilibrium in real GDP.

Government should have regular update on the economy and should have optimum grip over it. Whenever government feels economy is running in bad conditions, then immediate action should be taken to prevent it. Keynes immediate idea was only this. He didn't propose that whole countries economy should be controlled by government but, it should have enough power over it to control. Government spending should increase during time

of recession to increase money circulation. But this spending should not be a bad investment on misguided ventures. This spending should be done very carefully, so that the spending is not just useful for temporary growth but, for future use as well.

But, for a country's economy to run successfully in a long run a combination of Hayek's and Keynes's theory should be implemented based on that particular situation demanding. When a government feels that its spending can further ruin the economy of the country, it should step behind instead of spending on unwanted ventures. But when there is need for spending and feels that this spending can be helpful in future as well and doesn't increase stress on economy than, it should go forward and continue it.(Taylor, 2012)

Tax cuts also should be done to limited extent and higher cuts in taxes can increase the savings of individuals and making money stagnant in their pockets. Thus the expected income and real income difference can increase to higher extent i. e. real income would be much smaller than expected. So, this is the reason why Keynes has proposed withdrawal and injection model as well to bring equilibrium among withdrawals and expenditures, which in turn brings real income to equilibrium position. Hence, Keynes income expenditure model shouldn't be implemented as it is but it should be implemented by making certain changes under certain conditions and in combination with other post Keynesian theories to be successful.