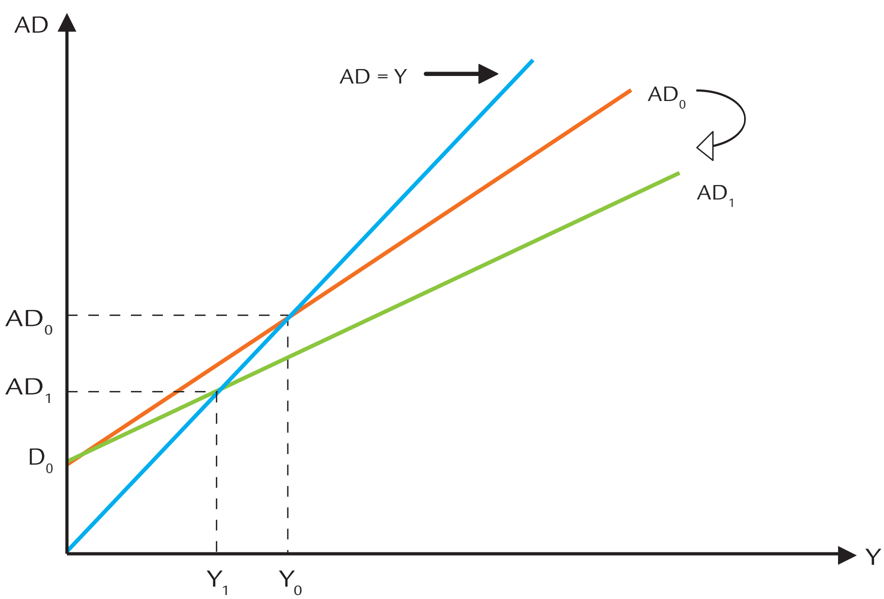
14.4.3 The savings paradox

This section looks at the savings paradox, which shows that an increasing general propensity to save does not necessarily increase total savings.

Assume that households start saving more of their income, i.e. they have an increased propensity to save, which corresponds to a fall in the marginal propensity to consume. As seen above, this means that the slope of the AD curve becomes less steep.

This is illustrated in Figure 14.11, in which the increasing propensity to save moves the AD curve from AD_0 to AD_1, while equilibrium income falls from Y_0 to Y_1.

Figure 14.11 *The effect of an increased propensity to save*



In other words, when households save a greater proportion of their income, the national income falls. The overall effect on savings is therefore unclear. People may save more of their income, but from a smaller income base.

The choice between spending and saving

Does that effectively mean that it is bad for the economy when people save? In the short term, yes. Higher savings mean lower consumer spending. Since consumer spending represents a large proportion of GDP, an increased propensity to save will generally lead to a fall in national income.

On the other hand, it is also well known that savings are the main source of funding for private-sector investment. The higher the level of investment, the greater the future capital stock, and therefore the **potential** national in-come. It can therefore be said that the choice between saving and spending is the choice between current and future consumption.

14.5 Fiscal policy in the Keynesian model

As mentioned above, this section looks at how both public spending and public investments are politically determined, and how official agencies can use fiscal policy to try to control the development of national income and employment.[123]

An expansionary fiscal policy, also called a loose fiscal policy, allows official bodies to:

- increase public spending and investments
- lower non-income-related taxes or increase transfer incomes
- lower income tax rates.

If they want to pursue a contractionary fiscal policy, also called a tight fiscal policy, they can:

- reduce public spending and investments
- raise non-income-related taxes or cut transfer incomes
- raise income tax rates.

14.5.1 Higher public spending and investments

Assume that the government wants to pursue an expansionary fiscal policy by increasing public spending and investments G. As seen above, aggregate demand, i.e. the AD curve in the Keynesian model, can be written as:

$$AD = (c \cdot (1 - t) - z) \cdot Y + E_0$$

123 However, fiscal policy is also critical for things like the balance of payments, inflation and the fixed exchange rate policy pursued in Denmark. These elements are discussed in Biede, 2015.

The demand side