Chapter 15: Fiscal Policy
Section 2

Prentice Hall

ECONOMICS

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Objectives

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1. **Compare and Contrast** classical economics and Keynesian economics.
2. **Explain** the basic principles of supply-side economics.
3. **Describe** the role that fiscal policy has played in American history.

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Key Terms

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- **classical economics:** a school of thought based on the idea that free markets regulate themselves
- **productive capacity**: the maximum output that an economy can sustain over a period of time without increasing inflation
- **demand-side economics**: a school of thought based on the idea that demand for goods drives the economy

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Key Terms, cont.

- **Keynesian economics**: a school of thought that uses demand-side theory as the basis for encouraging government action to help the economy
- **multiplier effect**: the idea that every one dollar change in fiscal policy creates a change greater than one dollar in the national income
- **automatic stabilizer**: a tool of fiscal policy that increases or decreases automatically depending on changes in GDP and personal income
- **supply-side economics**: a school of thought based on the idea that the supply of goods drives the economy

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Introduction

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- What economic ideas have shaped fiscal policy?
  - Classical economics
  - Keynesian economics
  - Supply-side economics

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Classical Economics

- The ideas that free markets regulate themselves is central to the school of thought known as classical economics.
- The Great Depression, however, challenged these ideas. The economy was unable to regulate itself, which led to high unemployment and immense bank failures.

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Classical Economics, cont.

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- Checkpoint: What event challenged the dominance of the classical economics school of thought?
  - The Great Depression highlighted a problem with classical economics: it did not address how long it would take for the market to return to equilibrium.

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Keynesian Economics

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- British economist John Maynard Keynes developed a new theory of economics to explain the Depression.
  - Keynes' approach focused on the workings of the economy as a whole.
  - Keynes argued that the Depression was continuing because neither consumers nor businesses had an incentive to spend enough to increase production.
  - The only way to end the Depression, according to Keynes, would be to find a way to boost demand.

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Government's New Role

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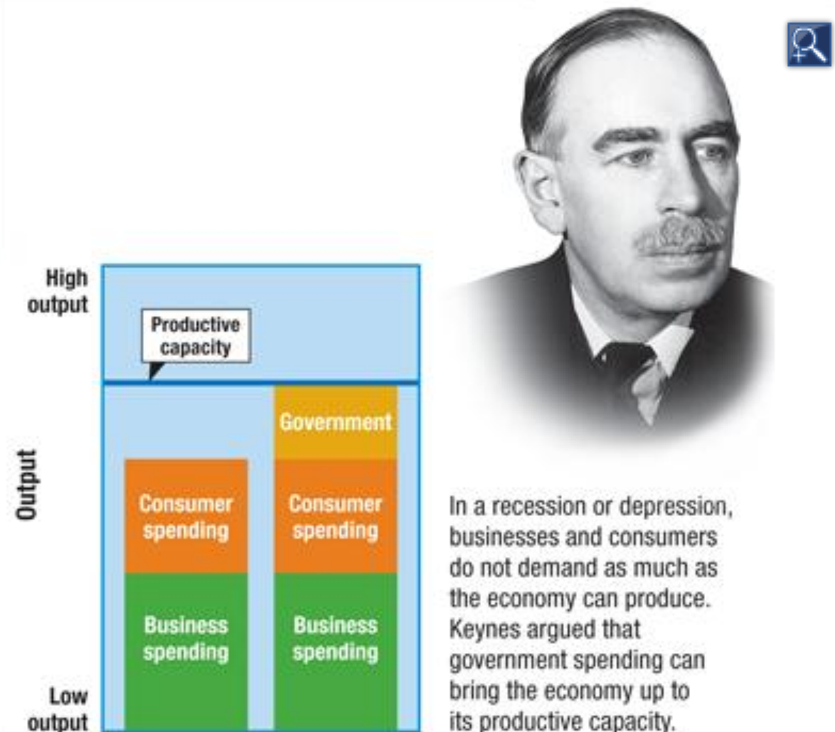
- Keynes believed that the government should be responsible for spending more money in order to boost demand.
  - The government could make up for the drop in private spending by buying goods and services on its own.



What role did Keynes envision for government in the economy?

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Avoiding Recession

- Keynes argued that fiscal policy can be used to fight periods of recession and periods of inflation.
  - The government can respond to a drop in consumer spending by increasing its own spending until spending in the private sector returns to a higher level.
  - Or it can cut taxes so that spending and investment by consumers and businesses increases.
  - Keynes also argued that the government can reduce inflation either by increasing taxes or by reducing its own spending.

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The Multiplier Effect

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- Keynesian economics holds that the key to the power of fiscal policy is the multiplier effect.
  - The multiplier effect states that every one dollar change in fiscal policy creates a change much greater than one dollar in the national income.
  - In other words, the effects of changes in fiscal policy are multiplied.

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Automatic Stabilizers

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- One of the most important goals that fiscal policy can achieve is a more stable economy.
- When set up properly, fiscal policy can come close to stabilizing the economy automatically.

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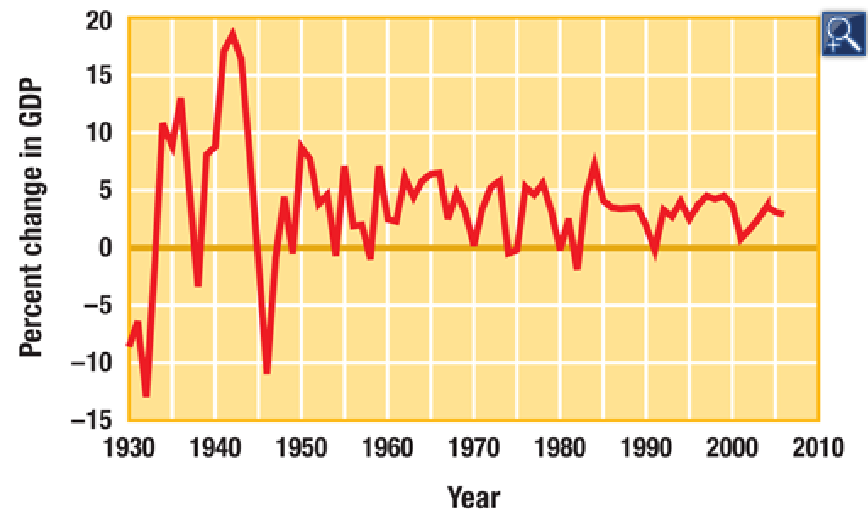
Automatic Stabilizers, cont.

- Taxes and most transfer payments are tied to the GDP and to personal income, so they change automatically.
- Thus, they are called automatic stabilizers—tools of fiscal policy that increase or decrease automatically depending on changes in GDP and personal income.



SOURCE: Bureau of Economic Analysis, *Historical Statistics of the United States*

How do the years after World War II show the effects of automatic stabilizers on the economy?

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Supply-Side Economics

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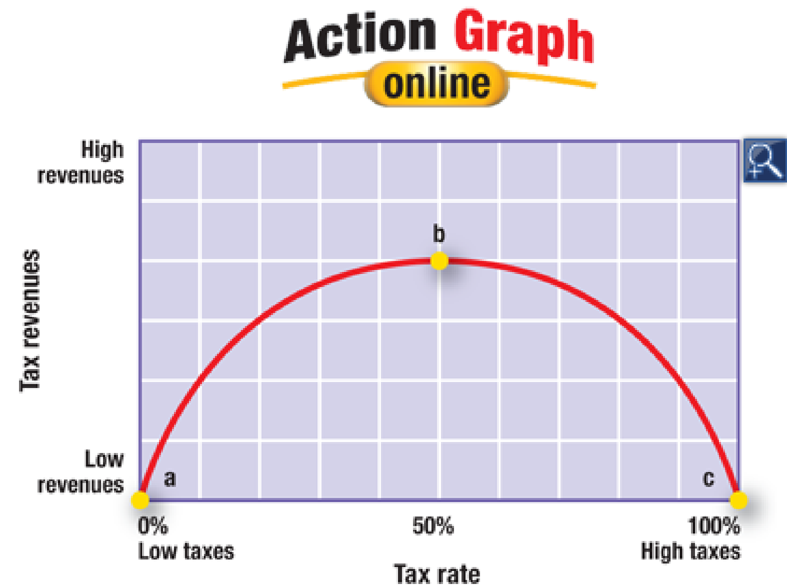
- Unlike demand-side economics, supply-side economics is based on the idea that the supply of goods drives the economy.
- Supply-side economists believe that taxes have a strong negative impact on economic output.
  - The Laffer curve illustrates the effects of high taxes on revenues.
  - According to the Laffer curve, what do both a high tax rate and a low tax rate produce?



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Taxes and Output

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- The heart of the supply-side argument is that a tax cut increases total employment so much that the government actually collects more in taxes at the new, lower rate.
  - Sometimes the government lowers taxes to stimulate the economy.
  - If you had a few more dollars each week from a tax cut, would you save it or spend it?

Economics & YOU

The Impact of Taxes

Paycheck $539.15

Sometimes, when the economy is overheated, the government resorts to increasing taxes on individuals. ***Tax increases can be very painful because they leave you with less money to spend on goods and services or to save for the future.***

These tax increases do more than help stabilize the economy and move it on to the next phase of the business cycle. ***They also provide the government with more resources to pay for a wide variety of public services.***

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Fiscal Policy in U.S. History

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- In the 1940s, as the country entered World War II, government spending increased dramatically.
  - Just as Keynesian economics predicted, the additional demand for goods and services moved the country sharply out of the Great Depression.
- Between 1945 and 1960, the United States economy was generally healthy.

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Fiscal Policy in U.S. History, cont.

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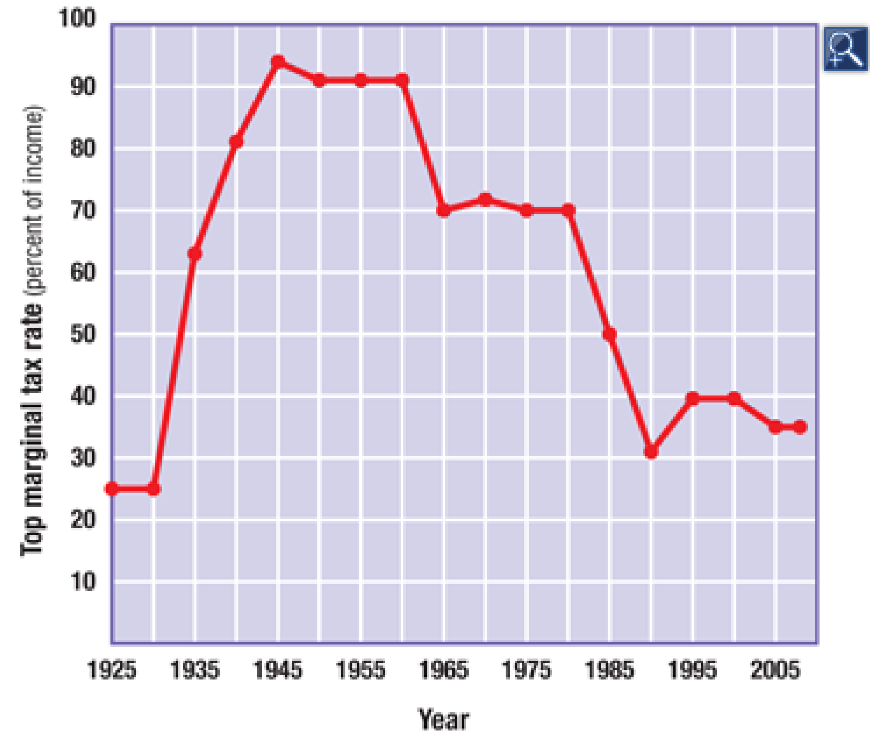
- In the early 1960s, President Kennedy cut taxes in order to boost productivity.
  - Keynesian economics was used on many other occasions in the 1960s and 1970s to adjust the national economy.
  - When were top marginal income tax rates at their highest?



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Supply-Side in the 1980s

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- President Ronald Reagan rejected Keynesian principles when he became President in 1981.
- Reagan proposed a tax cut that, once in place, reduced taxes by 25 percent over three years.
  - In a short time, the economy recovered and flourished.
  - Reagan did not believe that government should spend its way out of a recession.

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Review

- Now that you have learned about the economic ideas that have shaped fiscal policy, go back and answer the Chapter Essential Question.
  - How effective is fiscal policy as an economic tool?

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