NAME ______________________ DATE ____________ CLASS ________

Reading Essentials and Study Guide

networks

Chapter 15: Fiscal Policy

Lesson 1 Demand-Side Policies

ESSENTIAL QUESTION

How does the government promote the economic goals of price stability, full employment, and economic growth?

Reading HELPDESK

Academic Vocabulary

unstable unsteady

Content Vocabulary

fiscal policy use of government spending and revenue collection measures to influence the economy

Keynesian economics government spending and taxation policies suggested by John Maynard Keynes to stimulate the economy; synonymous with fiscal policies or demand-side economics

multiplier change in overall spending caused by a change in investment spending

accelerator change in investment spending caused by a change in overall spending

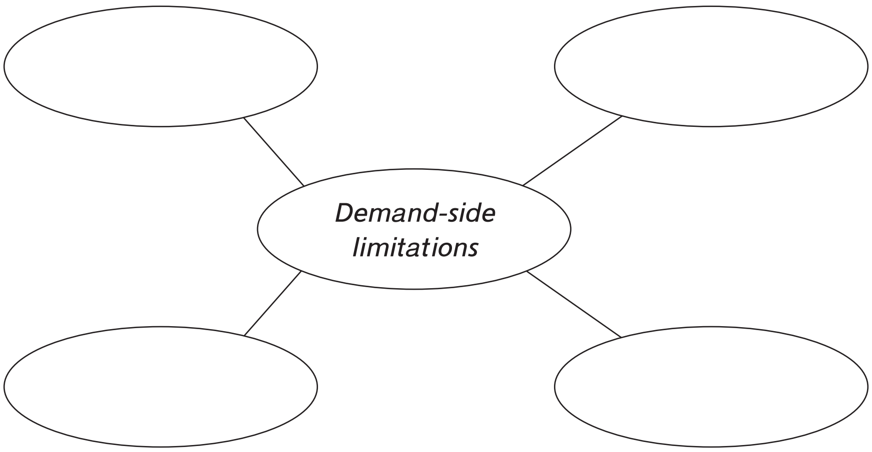
automatic stabilizer programs that automatically provide government benefits during an economic downturn; unemployment, insurance, and entitlement programs

unemployment insurance government program providing payments to the unemployed; an automatic stabilizer

entitlements program or benefit using established eligibility requirements to provide health care, food, or income supplements to individuals

TAKING NOTES: *Key Ideas and Details*

Use a graphic organizer like the one below to identify the limitations of demand-side policies.



Keynesian Economics

Guiding Question *How were Keynes's ideas different from what is in practice today?*

*Whenever the economy is doing poorly, people tend to look for solutions from the federal government. They may look for changes in **fiscal policy**. This is the federal government's attempt to help the economy through taxes and government spending.*

Fiscal policies come from **Keynesian economics**. This is a method meant to lower unemployment and raise output by stimulating aggregate demand. John Maynard Keynes was a British economist and the most important economic philosopher since Adam Smith. He put forth these theories in 1936. His ideas had a great influence on many economists until the 1970s.

In the 1930s, Keynes offered his basic macroeconomic framework, or model. It has come to be known as the aggregate output-expenditure model, and looks like this: $GDP = C + I + G + (X - M)$. In this model, "C" stands for household or consumer spending. "I" stands for the investment or business sector. "G" stands for the government. In the last group, the net foreign sector, "M" stands for imports and "X" stands for exports. GDP stands for gross domestic product, the total output of the economy.

Depression-Era Economics

Keynes wrote in Great Britain during the global depression in the 1930s. The Great Depression in the United States was a part of this global depression.

When Keynes created his equation, he reasoned that any change in GDP on the left side could be linked to changes on the right side. The question was: Which of the four components was causing the instability, and by how much?

Keynes said that the impact of the net foreign sector $(X - M)$ was so small that it could be ignored. The government sector (G) was not the problem either, because its expenditures were normally stable. Spending by the consumer sector (C), was the most stable of all. That led Keynes to argue that **unstable** spending by the business or investment sector (I) was why GDP fell during those years.

The Multiplier

Keynes correctly decided that spending by the investment sector was not only unstable, but it also has a magnifying effect on GDP. Each change in the investment sector rippled through the economy and became stronger as it went along. For example, if investment spending fell by $50 billion, many workers would lose their jobs. These workers in turn would spend less and pay fewer taxes. Soon, the spending by all sectors would drop by more than the initial decline in investment.

This effect is called the **multiplier**. It means that a change in investment spending will have a larger effect on total spending. Studies say that in today's economy the multiplier is about 2. So if investment spending goes down by $50 billion, the decline in overall spending will reach $100 billion. The multiplier also works in the other direction. An increase in spending by $50 billion will increase overall spending by $100 billion.

The Accelerator

*Keynes also identified an **accelerator**. This is the change in investment spending caused by a change in total spending. As overall spending goes down or decreases, investors become more careful and invest less. This behavior then causes overall spending to go down even more.*

When the multiplier and the accelerator combine, they push GDP down deeper and faster until it begins spiraling out of control. People clearly saw this happen during the worldwide depression. On top of that, when consumers also became more cautious and tried to save money, they pushed GDP down or kept it low.

Reading Progress Check

Analyzing What does Keynesian economics say is the economic role of the government?

____

____

____

____

Impact of Demand-Side Policies

Guiding Question *What are the goals of demand-side policies?*

Keynes concluded that the problem during the Great Depression was a lack *of spending. Maybe, then, an increase in spending would drive GDP back up, fighting the effects of the multiplier and accelerator.*

Role of Government

His solution was fairly simple. Only the government is big enough to cancel out or equalize changes in investment-sector spending. After all, spending by the consumer sector, C, is relatively stable. And spending by the net-foreign sector, (X − M), is too small to make much difference. This leaves only the government sector, G, to offset the fall in the business sector, or I, spending.

The G sector could spend to make up for the decline in spending by the I sector. A less direct approach was to have government encourage businesses and consumers to spend by lowering taxes and other measures.

Exploring the Essential Question

After you graduate from high school, you are planning on getting more education—either training in technology or attending college. Both types of post-high school education are expensive and you will need a loan. You explore the student loan program run by the government. Write a paragraph explaining whether or not you think the government student loan program is an example of Keynesian economics. Give your reason.

____

____

____

____

How Deficit Spending Works

Suppose there was a $50 billion decline in business spending. According to Keynesian doctrine, the government could spend $10 billion to build a dam, give $20 billion in grants to cities to fix up neighborhoods, and spend another $20 billion in other ways. As G increases to offset the decrease in I, the overall sum of C + I + G + (X − M) would remain the same.

Or, instead of spending $50 billion, the government could reduce taxes. Then consumers and businesses could spend the $50 billion they did not pay in taxes. This would offset the decline in investment spending and again, the sum of C + I + G + (X − M) would not change.

Either way, the government would run the risk of a short-term budget deficit. It would need to borrow to make it up. In Keynes's view, that deficit would be unfortunate but needed to stop further declines in economic activity. However, when the economy recovered, tax collections would rise, and the debt could be paid back. This justification for *temporary* federal deficits is a lasting contribution of Keynesian economics. It was also a major departure from economic ideas of his time.

"Priming the Pump"

By the 1960s, economists talked confidently, or assuredly, about "priming the pump." The term suggested that only a small amount of government spending was needed to initiate a bigger round of overall spending.

The economy had come through the Great Depression of the 1930s. Then huge government spending during World War II had driven the U.S. economy to new heights. Models that used multiplier-accelerator interactions were popular. But the limits of demand-side economics were not yet fully understood.

Automatic Stabilizers

Another key part of demand-side policies is the role of ***automatic stabilizers****. These are programs that automatically trigger Congress-approved benefits if changes in the economy threaten income. They keep purchasing power for people who get them from falling below a floor, or lower limit. This helps the economy by keeping up demand while providing a safety net for individuals.*

One important automatic stabilizer is the progressive income tax. For example, if your father loses his job or works fewer hours and earns less, he will end up in a lower tax bracket. So he will pay fewer taxes. That leaves him with more money to spend than he would have had otherwise.

He may also receive **unemployment insurance**. This is insurance that workers who lose their jobs can collect from individual states for a set time. It cannot be collected by people who are fired because of misconduct (bad behavior) or who just quit.

Most **entitlements**, or programs that help people get by in times of economic hardship, act as automatic stabilizers. An entitlement is a large social program that uses set eligibility rules to provide income support. For example, people who can't work because of major disabilities or retire by a certain age can receive checks from Social Security.

Automatic stabilizers, along with entitlement programs, are Keynesian. This is because they are intended to put a floor, or provide some stability, under consumer purchasing power when economic times are hard. They are also intended to react quickly to difficult economic situations because the relief does not have to wait for Congress to act. For example, people who become unemployed can receive help in a matter of weeks.

Reading Progress Check

Summarizing How did the Great Depression experience affect economists' views?

____

____

____

____

Limitations of Demand-Side Policies

Guiding Question *Why has the government typically been unable to reduce spending after business spending has recovered?*

Keynes envisioned (saw) the role of government spending as a counterbalance to changes in investment spending. In his framework, the government could increase its spending to offset declines in investment spending. It could then decrease its spending when the business sector recovered. In practice, however, things are not so simple. The government has not been able to respond as quickly and as flexibly as it needed to.

The Problem of Leads and Lags

Government spending is delayed for three reasons:

- The *recognition* lag. It takes time to see the problem. Because it takes months to collect good data, six months or more might pass before everyone sees that GDP has stopped growing.
- The *legislative* lag. It also takes time to agree on the solution. It might take as long as two years to pass simple laws that need modest expenditures. Congress is likely to fight over, and so delay, spending big enough to fix a major decline in business spending. This is especially true when they insist that some of that spending be in their own states and districts.
- The *implementation* lag. This is the amount of time it takes for an approved spending project or tax cut to actually pump money into the economy. For example, a law for a new highway or bridge might need years of planning, surveying, and buying properties. Then there will be construction and paving, with money trickling out along the way.

How is it possible to start government spending with enough lead time (time ahead of the problem) to offset the likely issues of an oncoming recession? Most recessions are over well before the legislative lag is overcome. All the lags together might add up to 4-5 years. Even the Great Recession of 2008–2009 lasted only 18 months.

Increased Dependency on Government

An equally large problem is the possibility, and some say probability, that people will become more and more dependent on the federal government, instead of on their own skills and initiative. For example, if people count on unemployment checks, they may be less likely to search for a new job or start a business.

Also, even if the government can increase federal spending in time to counter a weak economy, cutting back later is much harder.

Reaching a "Tipping Point"

It is likely that a tipping point (forced change) will come when people decide that the burden of taxes needed to finance government will outweigh the benefits. No one knows exactly when this will happen because huge shifts in public opinion take place slowly. They are also hard to measure.

Most observers feel that the tipping point was coming with the supply-side economics of Ronald Reagan's presidency. This began in 1981. Others think that the tipping point might have occurred with conservative politicians like Steve Forbes. He campaigned on a 17% flat-tax platform that promised lowered government spending in 1996.

Some people point to the rise of the conservative Tea Party with its strong opposition to government spending. Their fight against the Affordable Care Act (ACA) in 2013 helped shut down the government. It also brought the country to the edge of default (being unable to pay its bills).

The Keynesian Legacy

Keynes died in 1946 just after the end of the Great Depression and World War II. The economic stimulus provided by wartime spending was driving the U.S. economy to new heights. Keynes never had time to think about the results of too much stimulation.

Even after the economy recovers, politicians have never been able to fully cut back on spending begun during a decline in business investment. People who personally benefit from it like the stimulus spending provided by other taxpayers. They also usually want more of it. To be popular with their constituents (voters), politicians tend to vote for more and more government spending.

Reading Progress Check

Analyzing Why are Keynes's ideas important in the study of economics?

____

____

____