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Reading Essentials and Study Guide

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Chapter 15: Fiscal Policy

Lesson 2 Supply-Side Policies

ESSENTIAL QUESTION

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

Reading HELPDESK

Academic Vocabulary

promote to advance or support

Content Vocabulary

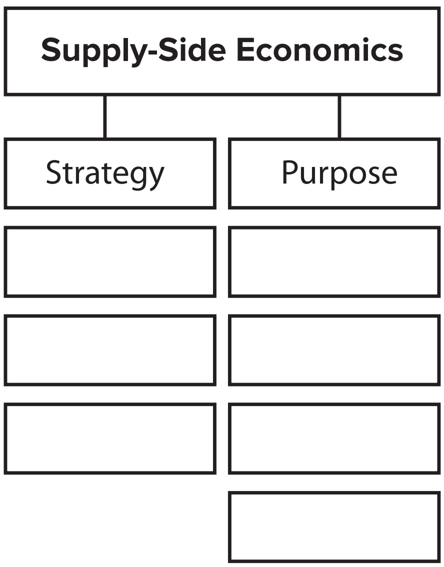
supply-side policies economic policies designed to stimulate the economy by removing government regulations and lowering marginal tax rates to increase production

Laffer curve a hypothetical, or possible, relationship between federal income tax rates and tax revenues

deregulation relaxation or removal of government regulations on business activities

TAKING NOTES: *Key Ideas and Details*

Use a graphic organizer like the one below to identify strategies or methods supply-siders used and the purpose that led to these actions.



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Goals of Supply-Side Policies

Guiding Question *In what ways are supply-side and demand-side policies different?*

The development of supply-side economics came as an alternative to demand-side economics. ***Supply-side policies*** *focus on producers, who are also suppliers. The goal is to stimulate (motivate) their output, and therefore provide jobs. Supply-side theory became important after demand-side economics seemed to falter in the 1970s. However, many of the policies advocated by supply-siders were already popular.*

Origins of Supply-Side Economics

In the 1970s demand-side policies did not seem to be controlling two of the nation's biggest economic problems, which were growing unemployment and inflation. Many Americans, including politicians, were ready to try something else.

The change came in 1981 when Republican Ronald Reagan became president. Supply-side policies, which matched his conservative politics, soon became the hallmark of his administration.

A Smaller Role for Government

A key goal for supply-siders is to reduce the economic role of the federal government. They argue that government involvement reduces production and slows growth. One strategy is to cut the number of agencies. Another is to cut federal spending.

President Reagan tried to shrink the federal government, but his efforts were mostly unsuccessful. Instead, he worked to lower tax rates. He hoped that the growing federal deficit would force Congress to accept less spending.

Lower Federal Taxes

Supply-siders also targeted federal taxes on individuals and businesses. Lower tax rates, they argued, allow people to keep more of the money they earn. This encourages them to work harder. In the long run, they will have more money to spend and businesses will produce more to meet greater demand. Government revenues also increase, they argue, because the additional business activity will be taxed.

During the 1980s, optimistic supply-siders even argued that lower income taxes would stimulate the economy so much that the government could collect even more taxes than before. This idea is expressed in the **Laffer curve**. It is a possible relationship between federal income tax rates and tax revenues.

The Laffer Curve

The Laffer curve in ***Panel A*** *of* ***Figure 15.1*** *shows a possible $0.2 billion gain in tax revenues after a lowering of income tax rates, shown on the horizontal axis. Tax relief, in theory, should move the economy from point a to point b. Also, the Internal Revenue Service (IRS) would collect more taxes, despite lower rates.*

This theory provided a seemingly good reason for lower tax brackets. In 1981 President Reagan and Congress cut income tax rates 25 percent over a three-year period. As **Panel B** in Figure 15.1 shows, income tax receipts adjusted for inflation actually *declined* from 2000 to 2004, even though personal income rose in each of those years. Unfortunately, the increased tax revenue collections predicted by the Laffer curve never happened. On the plus side, it is likely that the yearly increases in personal income helped cause economic growth.

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Deregulation

Supply-siders also have sought ***deregulation****. This is the relaxing or removing of government regulations on the activities of firms in certain industries.*

Democrats liked the idea of deregulation, too. For example, in 1980 Democratic President Jimmy Carter signed a major Savings and Loan (S&L) deregulation act. President Reagan then took another step by reducing the number of inspectors in the S&L industry. He did this with the idea that competition would do the job.

Exploring the Essential Question

Many people favor deregulation, arguing that competition in a free market is enough to keep firms in line. They believe that consumers will avoid firms that act unfairly and force them to correct their ways or go out of business. Do you agree? Are there situations where the government needs to regulate an industry? Explain.

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However, the S&Ls at the time were severely underfunded. In the late 1980s and early 1990s about one-quarter of the country's S&Ls failed. Federal S&L insurance was used to repay money that depositors lost. However, American taxpayers had to bail out the S&L insurance fund.

Despite this major crisis, the American economy has seen a flood of deregulation. It has occurred in industries ranging from airlines and banking to telecommunications and interstate trucking.

Reading Progress Check

Identifying When did supply-side economic policies begin to grow in popularity?

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Impact and Limitations of Supply-Side Policies

Guiding Question *How does increasing supply help improve the economy?*

Supply-siders believe that their policies have never been fully tested. For example, deregulation in industries such as oil and gas and cable television was offset by increased federal spending. The smaller government that supply-siders imagined did not develop. So we do not know whether a smaller government would make the economy more efficient.

It is also true that tax collections did not rise when tax rates were lowered. This decreased support for the supply-side views.

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President Reagan's Budget Priorities

For example, President Reagan cut domestic programs by about $39 billion during his first year in office. But he also raised spending on national defense and in several other areas. The net result was a yearly increase *in government spending of about 2.5 percent.*

Tax Rates and Economic Growth

Supply-siders predicted that lower tax rates and reduced government regulation would provide a climate for strong economic growth. The performance of the economy during Reagan's two terms in office partly backed them up. Real GDP, or GDP adjusted for inflation, started to grow in late 1982 and continued to grow for 92 months. This was a peacetime post-World War II record. It easily shattered the previous 58-month record. However, the record growth was not entirely due to supply-side policies. Huge military spending also provided economic stimulus.

Tax Rates and Tax Revenues

As we saw in Panel B of Figure 15.1, President Reagan's tax cuts lowered revenues. When President Bush reduced rates again in 2001, revenues also fell. Thus one of the main foundations of the supply-side ideas—that tax cuts would lead to higher tax revenues—has been proven false.

Deregulation and Economic Growth

Even so, policies that promote productivity, reduce unnecessary paperwork, or otherwise stimulate the economy to grow to its maximum potential are certainly worthwhile. Almost everyone, including demand-siders, favors policies that make production more efficient.

Many economists believe that supply-side policies during both the Reagan and Bush presidencies made the economy less stable. The federal tax structure became less progressive, or modern, and "safety net" programs were weakened. However, keep in mind that supply-side economics is designed to **promote** economic growth, not provide stability.

Supply-and Demand-Siders–A Final Comparison

The differences between supply-side policies and demand-side policies are smaller than most people think. Both policies, which are summarized in ***Figure 15.2****, have the same goal. They want to increase production and decrease unemployment without increasing inflation.*

Demand-siders hope to achieve this by stimulating the economy on the demand side of the market. Supply-siders hope to achieve the same ends with policies that stimulate the supply side of the market. Both approaches work to achieve a common economic outcome.

Reading Progress Check

Interpreting What are the main goals of supply-side economists?

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