Tax cuts and the economy

Running Head: Tax Cuts and the Economy Tax Cuts and the Economy [Institute's Tax Cuts and the Economy In order to revive the economy, one path that the government can take is that of an expansionary fiscal policy (Abel, Bernanke, & Croushore, 2008). An expansionary fiscal policy is anything that increases the size of the government budget deficit G-T, i. e. either decreasing T or increasing G (Abel, Bernanke, & Croushore, 2008). According to the Keynesians, a tax cut helps stimulate the economy via the aggregate demand channel. Aggregate demand is given by: AD= C+I+G+(X-M) A decrease in taxes results in an increment in the disposable income that causes an increase in consumption. This increase in C leads to an increase in AD and causes the AD curve to shift rightwards. As the graph depicts, this leads to higher output at each given price level (Abel, Bernanke, & Croushore, 2008). This higher output or increase in GDP results in stimulation of the economy. (Abel, Bernanke, and Croushore, 2008) In this case, the tax multiplier (the change in output due to a unit change in taxes) is given by the following relation: (Abel, Bernanke, and Croushore, 2008) This implies that a decrease in taxes leads to an increase in output, the same result proven earlier graphically. Another way tax cuts help revive the economy is through the supply side channel. A tax cut leads to greater disposable income, thus there is greater incentive for people to work (Labont, 2010). The greater incentive to work results in greater supply i. e. there is an increase in aggregate supply. This also helps revive the economy. Thus, it is evident how tax cuts help stimulate a country's economic activity. However, it is important to point out that these results are largely theoretical and in practicality a multitude of factors, such as the effectiveness of the fiscal policy and the credibility of the government interact to determine the effect on the economy. References Abel, A. B., Ben S. B., Dean C. (2008). Macroeconomics. Pearson Education, Inc. Labont, Marc. (2010). “ What Effects Would the Expiration of the 2001 and 2003 Tax Cuts Have on the Economy?” Congressional Research Service. Volume 2, pp. 7-5700.