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Keynesian economics, aggregate demand or spending is what drives the performance and growth of the economy

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Editorial

Fiscal policy is largely based on the ideas of British economist John Maynard Keynes (1883-1946), who argued that economic recessions are due to a deficiency in the consumption spending and business investment components of aggregate demand. Keynes believed that governments could stabilize the business cycle and regulate economic output by adjusting spending and tax policies to make up for the shortfalls of the private sector. His theories were developed in response to the Great Depression, which defied classical economics' assumptions that economic swings were self-correcting. Keynes' ideas were highly influential and led to the New Deal in the U.S., which involved massive spending on public works projects and social welfare programs.

In Keynesian economics, aggregate demand or spending is what drives the performance and growth of the economy. Aggregate demand is made up of consumer spending, business investment spending, net government spending, and net exports. According to Keynesian economists, the private sector components of aggregate demand are too variable and too dependent on psychological and emotional factors to maintain sustained growth in the economy.1

Pessimism, fear, and uncertainty among consumers and businesses can lead to economic recessions and depressions, and excessive exuberance during good times can lead to an overheated economy and inflation. However, according to Keynesians, government taxation and spending can be managed rationally and used to counteract the excesses and deficiencies of private sector consumption and investment spending in order to stabilize the economy.

When private sector spending turns down, the government can spend more and/or tax less in order to directly increase aggregate demand. When the private sector is overly optimistic and spends too much, too fast on consumption and new investment projects, the government can spend less and/or tax more in order to decrease aggregate demand.

This means that to help stabilize the economy, the government should run large budget deficits during economic downturns and run budget surpluses when the economy is growing. These are known as expansionary or contractionary fiscal policies, respectively.

Expansionary Policies

To illustrate how the government can use fiscal policy to affect the economy, consider an economy that's experiencing a recession. The government might issue tax stimulus rebates to increase aggregate demand and fuel economic growth.

The logic behind this approach is that when people pay lower taxes, they have more money to spend or invest, which fuels higher demand. That demand leads firms to hire more, decreasing unemployment, and to compete more fiercely for labor. In turn, this serves to raise wages and provide consumers with more income to spend and invest. It's a virtuous cycle, or positive feedback loop.

Rather than lowering taxes, the government may seek economic expansion through increases in spending (without corresponding tax increases). By building more highways, for example, it could increase employment, pushing up demand and growth.

Expansionary fiscal policy is usually characterized by deficit spending, when government expenditures exceed receipts from taxes and other sources. In practice, deficit spending tends to result from a combination of tax cuts and higher spending.