

10 Trade-offs and policy limits – Part 2

Name: _____ Class: _____ Date: _____

Vocabulary

Write each word three times.

English	Write it 3 times (English)
trade-off	_____
Phillips curve	_____
Laffer curve	_____
crowding out	_____

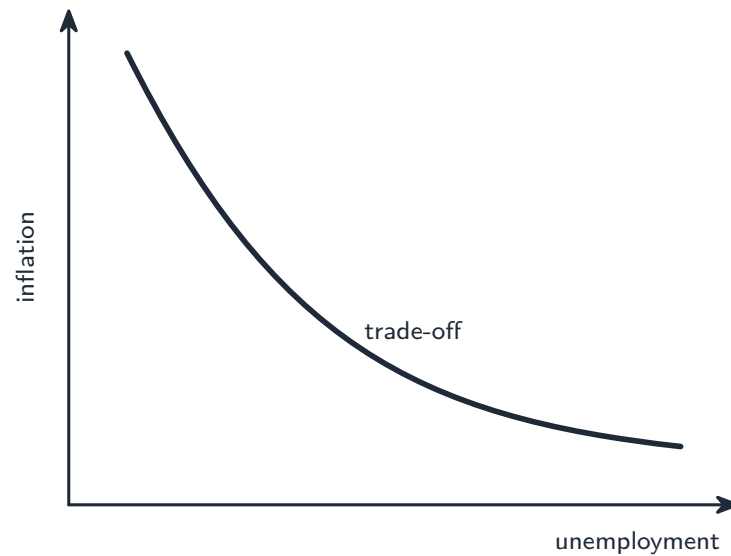
Recall

The government's aims often clash, and its tools have limits. Two famous curves show why.

New ideas

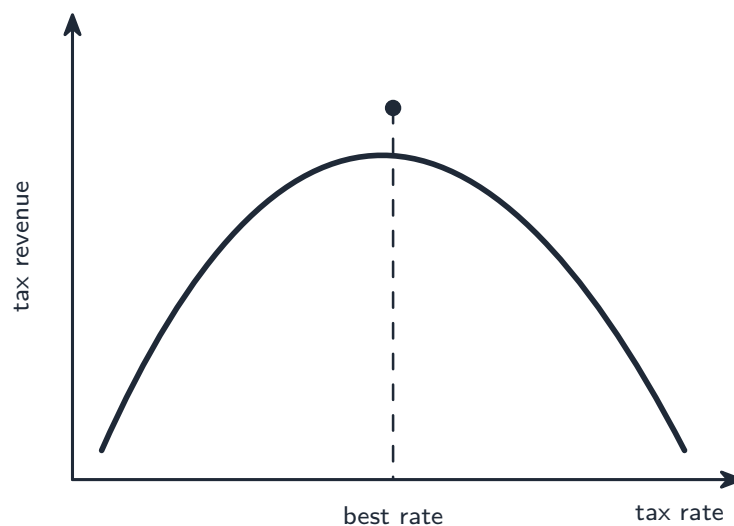
Read these first, then do the Practice.

■ 1 The Phillips curve



Aims pull against each other, so a government faces a **trade-off**. The **Phillips curve** shows one: cutting unemployment tends to push inflation up.

■ 2 The Laffer curve



The **Laffer curve** warns that as the tax rate rises, tax revenue first rises but then *falls* – very high rates discourage work. Heavy government borrowing can also cause **crowding out**, raising interest rates and reducing private investment.

Watch out: the Phillips curve shows a *trade-off* – lower unemployment tends to mean higher inflation. The Laffer curve warns that beyond a point a *higher* tax rate

gives *lower* revenue. Crowding out: heavy government borrowing raises interest rates, cutting private investment.

Practice

Try these in order.

10.6 What is a *trade-off*? [1]

10.7 What trade-off does the *Phillips curve* show? [1]

10.8 According to the *Laffer curve*, what happens to revenue if the tax rate gets very high? [1]

10.9 Why might a very high tax rate lower revenue? [1]

10.10 What is *crowding out*? [1]

10.11 Challenge. A government raises the top income-tax rate from 50% to 80%, but tax revenue *falls*. Use the Laffer curve to explain why. [2]
