11 Revision – Demand-side and supply-side policies

Supply side policies are designed to increase LONG-RUN AGGREGATE SUPPLY (LRAS), also known as the full employment level of output.

Advantages of supply-side policies

- **Lower inflation –** shifting aggregate supply (AS) to the right will cause a lower price level. By making the economy more efficient supply-side policies will help reduce cost-push inflation.
- **Lower unemployment –** supply-side policies can help reduce structural, frictional and real-wage unemployment and therefore help reduce the natural rate of unemployment.
- **Improved economic growth –** supply-side policies will increase economic growth by increasing AS.
- **Improved trade and balance of payments –** firms will become more competitive so they will be able to export more.

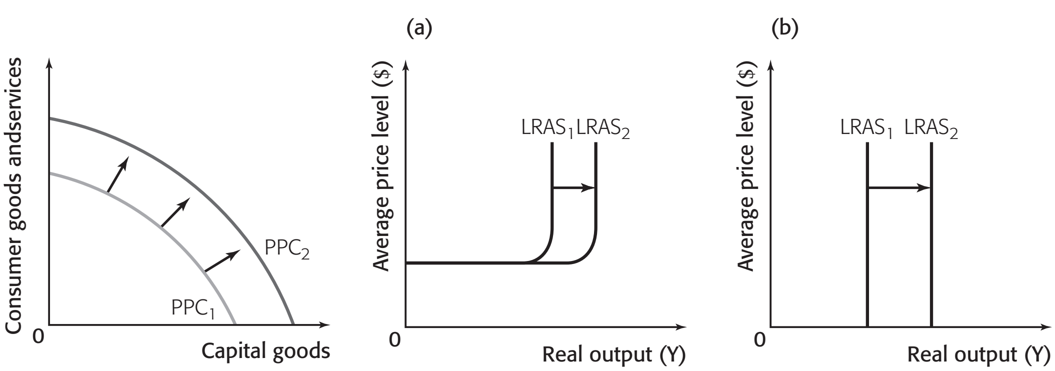
We put such policies into two categories: interventionist and market-oriented.

INTERVENTIONIST	How?	Disadvantages/Limitations
Education and training to: • raise levels of human capital • make labour more flexible to cope with changing structure of economy.	The government provides education, gives incentives to firms to do on-the-job training and finances apprenticeship programmes.	Interventionist supply-side policies are costly (so there is an opportunity cost for the government, as it means that the money cannot be spent on the next best alternative). Such policies can only be effective over the longer term. (*Do **NOT** confuse interventionist with Keynesian when it comes to supply-side policies. ALL economists support the use of interventionist supply-side policies, no matter what their perspective.*)
Research and development (R&D) to: • develop new technologies or production techniques • improve efficiencies.	R&D takes place in government research institutions. Finance is provided for R&D in universities. There are tax breaks for firms to give them more incentive to spend on R&D.	
Improved infrastructure to: • allow for better transportation linkages in the economy • allow for better telecommunications linkages in the economy. Infrastructure is what enables economic activity to take place	Government spending on infrastructure.	

MARKET-ORIENTED		
Reduction in direct taxes (income tax)	People will have greater incentive to work hard, become more productive or join the labour force if they know that they can keep a larger share of their income. *(Note that cuts in income taxes are both a supply-side policy and a demand-side policy.)*	There may possibly be less income for governments (unless the Laffer curve hypothesis is to be believed).
Reduction in direct taxes on firms (corporate tax)	If firms pay less tax, they will have more profits left for investment. *(Note that cuts in corporate taxes are both a supply-side policy and a demand-side policy.)*	There may possibly be less income for governments (unless the Laffer curve hypothesis is to be believed).
Labour market reform may include: • reduction in trade union power • reduction in minimum wages *(Note that the government would not actually have to reduce the nominal wage, it could just leave it at the same level. Inflation would erode the real value of the minimum wage)* • reduction in unemployment benefits.	The job of unions is to protect their own workers. This means that the number of working hours is limited, and the ability to hire and fire workers is limited. Without unions, firms may be able to increase output. There will be lower costs of production for firms. Without unemployment benefits, unemployed workers will have greater incentive to take on available jobs.	A lower level of trade union power is likely to result in less job security and worsening conditions for workers. There will be a reduction in living standards for workers on the minimum wage and for the unemployed.
Deregulation	Regulations raise the costs for firms.	There may be negative effects on labour or the environment.
Deregulation of financial markets	More firms are allowed to supply financial services, so there is more competition and borrowing costs are reduced.	Too much lending will have an inflationary effect. Too much risky lending will mean that people are unable to repay.
Privatization	Free market economists argue that resources are most efficiently allocated by market forces, and so advocate privatization to increase efficiency.	Some firms are nationalized so that they can provide an essential service, e.g. water, electricity or railways, at lower prices and in areas where there might not be sufficient demand for private firms to operate.

Long-run aggregate supply (LRAS) – what shifts it?

A shift of the LRAS curve to the right is equivalent to an outward shift of the PPC curve, as shown below:

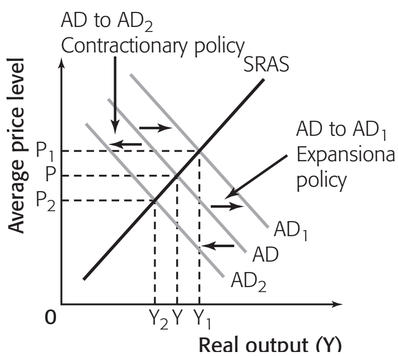


A shift in the LRAS can be shown from either a neo-Keynesian perspective, as in (a) above, or a neo-classical perspective, as in (b).

The LRAS curve will shift to the right if there is an improvement in the quantity and/or quality of the factors of production in the economy.

Demand-side polices – what do they do?

- They are used to shift the AD curve.
- They can expand the economy (expansionary policies).
- Or they can shrink the economy (contractionary policies).



- An expansionary policy increases output and employment (Y to Y_1) and increases inflation (P to P_1).
- A contractionary policy decreases output and employment (Y to Y_2) and decreases inflation (P to P_2).

What types of demand-side policy are there?

Fiscal policy

- Governments alter their own expenditure and taxation to affect the economy.

To expand the economy, the government could reduce direct taxes and increase its spending.

- AD would shift to the right.
- This would help to solve disequilibrium unemployment (demand-deficient unemployment), but would cause demand-pull inflation.

To contract the economy, the government could increase direct taxes and decrease its spending.

- AD would shift to the left.
- This would help to solve demand-pull inflation but would cause disequilibrium unemployment (demand-deficient unemployment).

Monetary policy

- Governments alter the interest rate and/or the supply of money to affect the economy.

To expand the economy, the government could reduce interest rates and increase the money supply.

- AD would shift to the right.
- This would help to solve disequilibrium unemployment (demand-deficient unemployment), but would cause demand-pull inflation.

To contract the economy, the government could increase interest rates and decrease the money supply.

- AD would shift to the left.
- This would help to solve demand-pull inflation but would cause disequilibrium unemployment (demand-deficient unemployment).

What are the problems?

- Demand side policies involve a trade-off.
- Usually, if inflation is improved, unemployment gets worse and vice versa.