Demand-Side vs. Supply-Side Economics

Social Studies 30-1

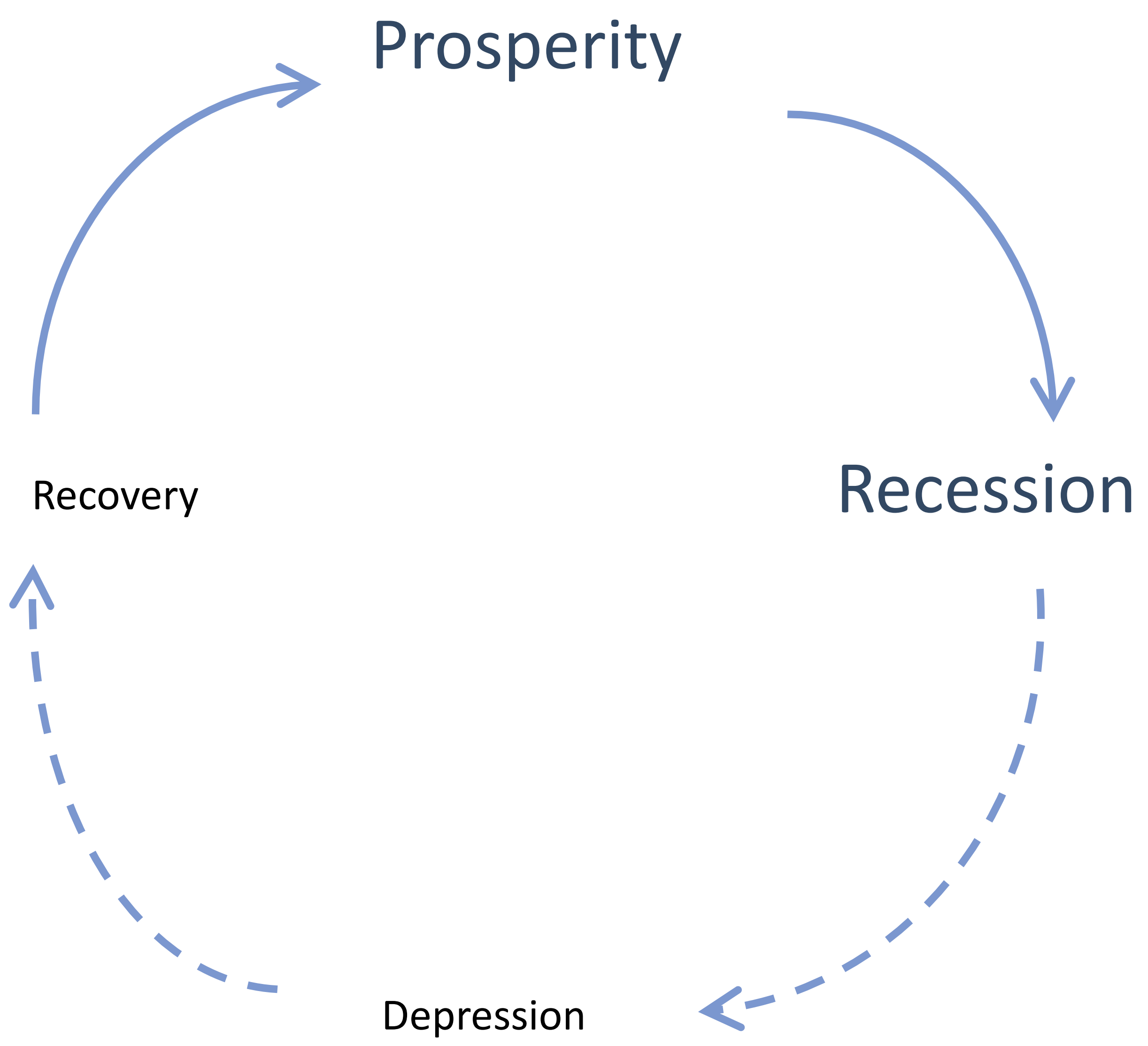
Vocabulary

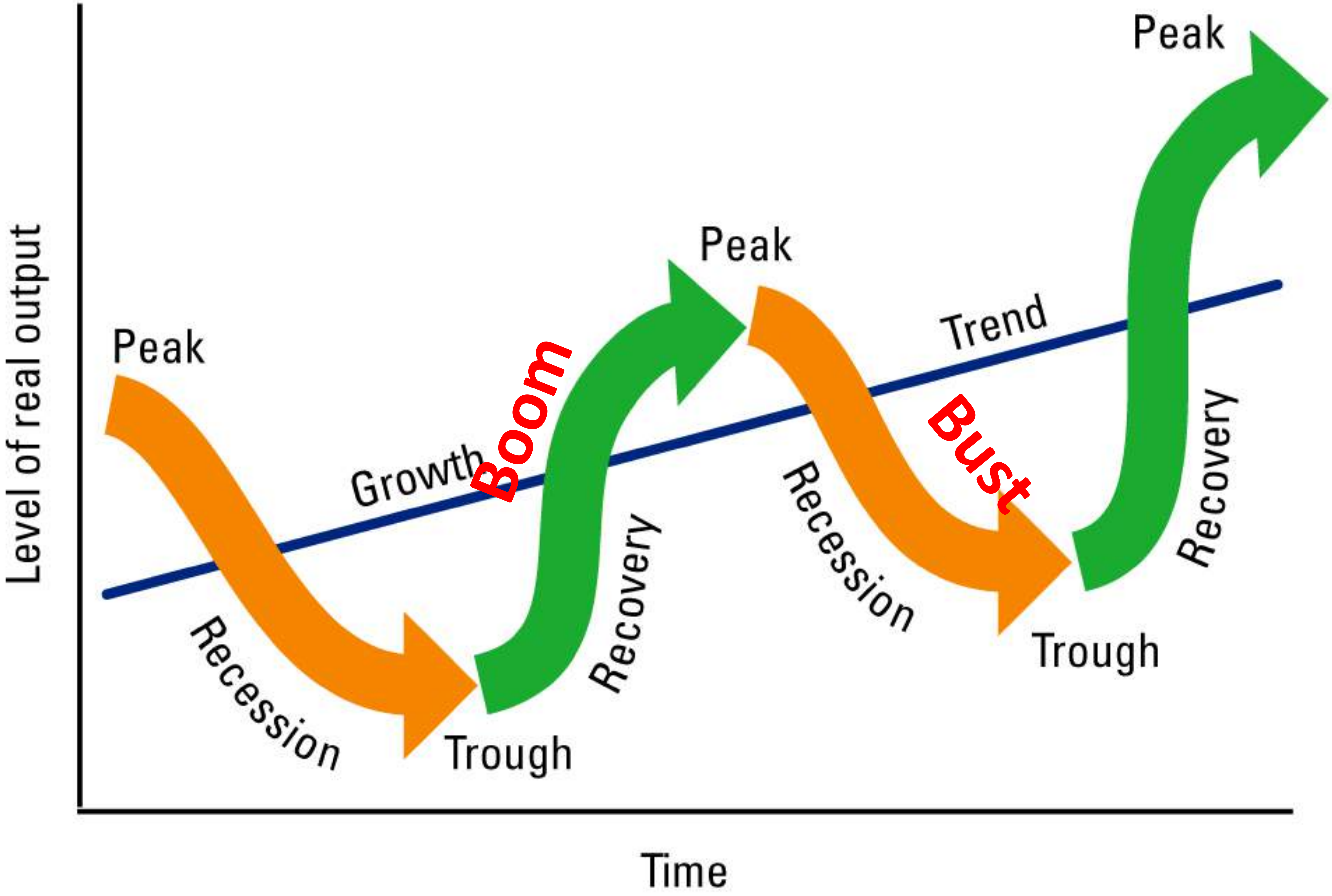
- **Depression:** A recession that lasts for more then about 6 months, and shows no signs of recovery any time soon.
- **Inflation:** “growth” or “prices are increasing; this only becomes a concern when the prices too high”; usually happens during prosperous times.
- **Prosperity:** when the economy is growing, and most people have an opportunity to work; people are happy and generally spending money. Also known as economic “Boom”
- **Recession:** Economics cannot grow indefinitely; Inflation will at one point drive the prices too high up. People will stop buying; less people spending money = less people working = the economy slows down.
- **Recovery:** a time of economic recovery and some growth in the business sector

The Business Cycle

The rise and fall of economic activity over time is called the Business Cycle

- Prosperity/Boom
- Recession
- Depression
- Recovery



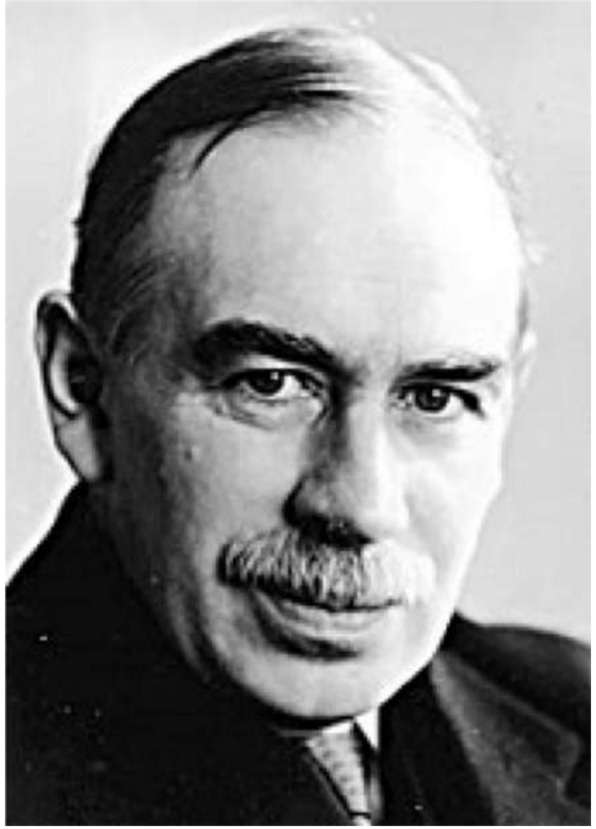

Level of real output
Peak
Peak
Peak
Recession
Recession
Trough
Trough
Recovery
Recovery
Growth
Boom
Bust
Trend
Time

Demand Side Economics (Keynesian Economics)

Demand-side economics is a macroeconomic theory which maintains that **economic** growth and full employment are most effectively created by high **demand** for products and services. According to **demand-side economics**, output is determined by effective **demand**.

Because **Keynesian economists** believe the primary factor driving **economic** activity and short-term fluctuations is the **demand** for goods and services, the theory is sometimes called **demand-side economics**.

John Maynard Keynes



John Maynard Keynes was a British economist, whose ideas fundamentally changed the theory and practice of macroeconomics and the economic policies of governments.

Keynes described his premise in “The General Theory of Employment, Interest, and Money.” Published in February 1936, it was revolutionary. It argued that government spending was a critical factor in a successful economy, meaning that an increase in spending would increase demand.

FDR used Keynesian economics to build his New Deal program.

Keynesian Economics

As the 1930s progressed, the recession deepened and no one seemed to be able to do anything about it. John Maynard Keynes (1883–1946), a British economist, studied the Depression and developed a new economic theory.

He believed that classical liberal economic theory, the basis for the market economy, was based on a fundamental error. Classical liberals believed that there would be full employment if supply and demand were in balance.

Keynes used the Great Depression as proof that this was not true. He stated that the economy was essentially unstable and a balance between supply and demand would not necessarily result in full employment because in times of stress, people hoarded money and failed to invest in the economy, thereby creating and prolonging a recession.

Keynesian Economics

Keynes wanted to avoid the destructive and unpredictable rollercoaster ride of this unregulated market system during which millions of ordinary people lost their jobs, savings, and homes.

According to Keynes's analysis, periods of inflation (the increase in the general price level of products, the cost of labour, and interest rates) are followed by periods of recession. Because the price of everything rises too high during the inflationary cycle (so factories cannot sell their products and cannot afford their workers), companies shut down and workers lose their purchasing power. This slowdown affects other companies, who also cut back.

A recession, if long and severe enough, becomes a depression. The Great Depression was only the worst of a series of wild fluctuations in the economy throughout modern history, and Keynes felt he had a relatively easy solution to this problem.

Keynesian Economics

The market system is driven by the simple laws of supply and demand. When goods are plentiful, prices come down, and when they are scarce, prices go up. This holds for labour and all other components of the market, including interest rates.

For defenders of classical liberalism, who dislike government interference in the economy, this variable characteristic of the market economy is like a natural law. If everyone knows that good times are followed by bad times, then it is everyone's responsibility to save for the bad times.

Classical liberals see no reason for governments to get involved in the economy, believing individuals should be responsible for their own financial situations. Keynes felt that few individuals could successfully predict the vagaries of the market, and thus most ordinary people would inevitably suffer. He felt he had a better solution.

Keynesian Economics

Keynes argued that the economic cycle of inflation followed by recession was caused by one factor: consumer demand. **All that was required to moderate market fluctuations was for someone, or something, to regulate consumer demand.** During inflationary times, such as the 1920s, governments through their central banks should raise interest rates, raise taxes, and reduce government spending on such things as building roads.

These simple acts would drain surplus money from the economy and “cool down” inflationary demand. As the economy cooled and approached a recession, the government and its central bank would lower interest rates, decrease taxes, and increase government spending, even if this resulted in a temporary deficit. **Deficit spending was an essential and radical part of his new theory.**

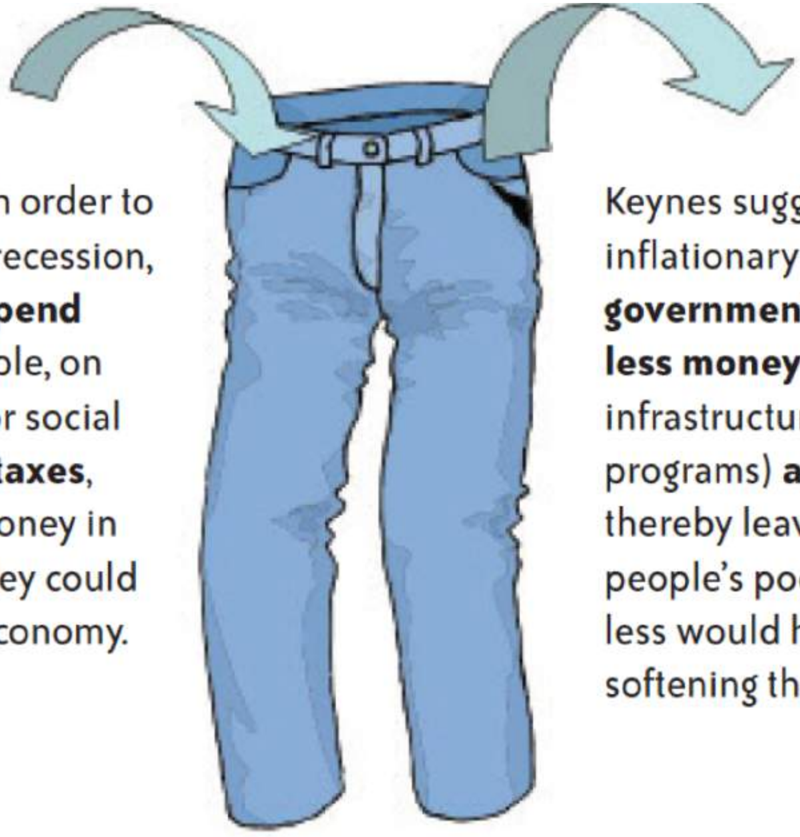
These actions would have the effect of pumping money back into the economy and this would cause the economy to grow again. Any deficit that the government incurred during this time would be eliminated during the next phase of the inflationary cycle. The government, according to Keynes, would regulate demand by manipulating the supply of money available to producers and consumers.

Keynesian Economics

This application of monetary and fiscal policy would lessen the effects of both inflation and recession and would still leave the free-market system largely intact.

- Monetary policy: refers to actions taken by the central bank of a country to control the supply of money. The most common tools used in monetary policy are raising or lowering interest rates, and printing or destroying money.
- Fiscal policy: refers to the direct taxing and spending functions of governments. Governments can raise or lower taxes, and raise or lower their spending on projects and programs. Governments are usually the biggest single spender in a modern economy, so these decisions have a direct effect on the economy of the country.

Keynes suggested that in order to lessen the severity of a recession, **governments should spend more money** (for example, on infrastructure projects or social programs) **and reduce taxes**, thereby leaving more money in people's pockets that they could spend or invest in the economy.



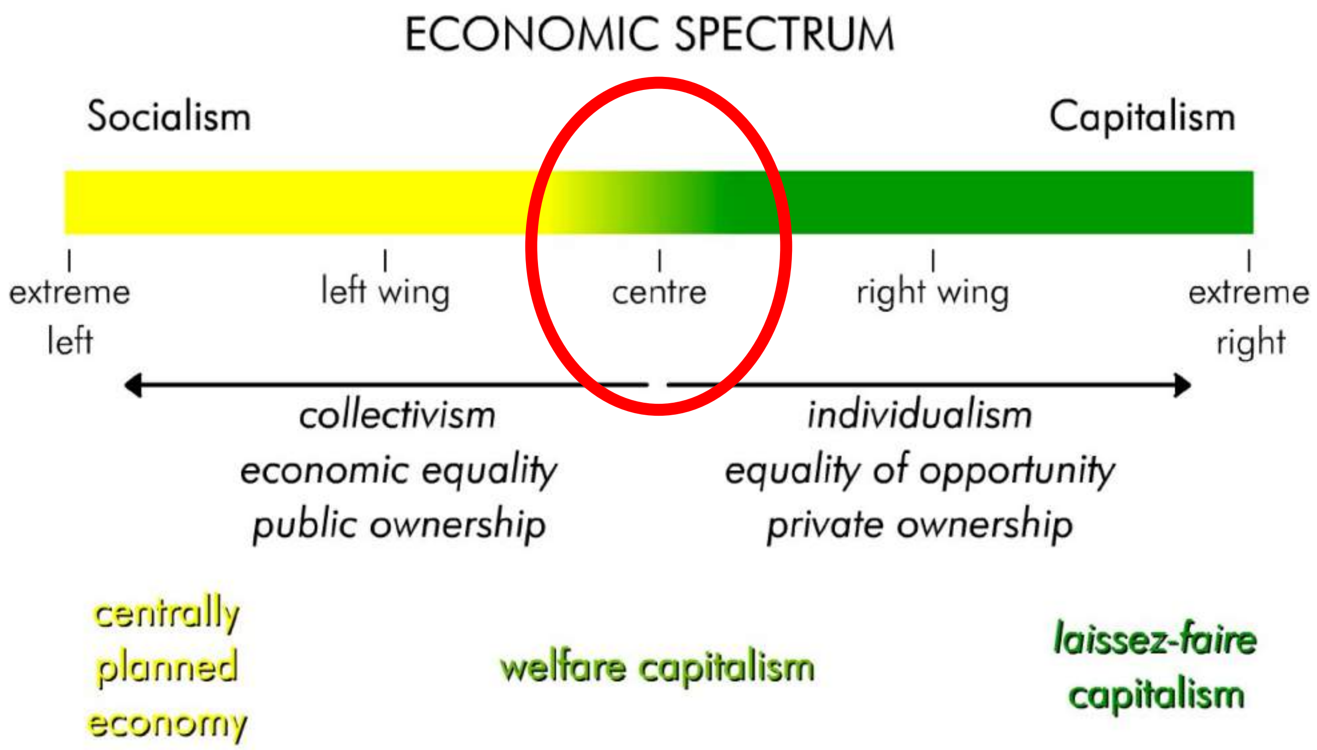
Keynes suggested that during inflationary ("boom") times, **governments should spend less money** (for example, on infrastructure projects or social programs) **and increase taxes**, thereby leaving less money in people's pockets. People spending less would have the result of softening the "boom".

On which side would the government be running a "deficit budget"?

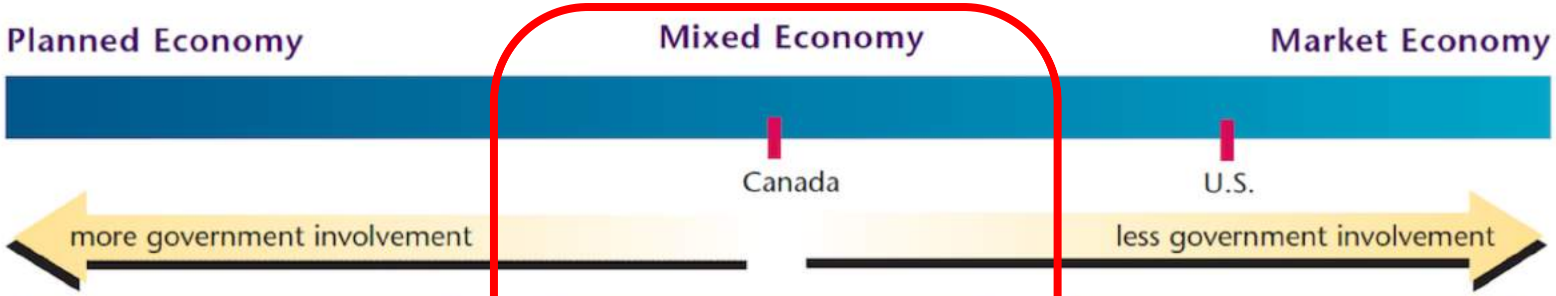
According to the model, how would the government eventually pay for this deficit?

Consider This…

To what extent can Keynes be considered the originator of the mixed economy, also referred to as “the modified market economy”?



THE ECONOMIC CONTINUUM



Planned Economy

At this end of the spectrum, government makes all the decisions about how to solve scarcity. It owns and manages the resources needed to produce things. It plans what will be produced and decides how to use limited resources.

Characteristics

- Resources are **publicly owned**.
- Government makes decisions on how to use resources.
- Individual consumers have little influence on economic decision making.

Mixed Economy

A mixed economy combines private ownership and government control. For example, private businesses own some resources and the government owns others. In mixed economies, the level of government involvement fluctuates depending what political party is in power.

Characteristics

- Some resources are publicly owned and some are privately owned.
- Individuals and government both make decisions about what to produce.
- Individual consumers and government influence economic decision making.

Market Economy

At this end of the spectrum, the choices of individuals solve scarcity. Private businesses own and manage resources. They sell their products to consumers, who make their own decisions about what to buy. Businesses succeed if they produce what consumers want. Otherwise, they fail. The government does not get involved.

Characteristics

- Resources are **privately owned**.
- Individuals make decisions on how to use resources.
- Individual consumers drive economic decision making by choosing what to buy.

Left Wing	Center	Right Wing

Public Direction	Private Direction

Planned Economy Centrally Planned Economy Command Economy	Mixed Economy	Free Enterprise Laissez-faire Invisible Hand

Communism	Socialism	Welfare Capitalism	Capitalism

Interventionist	Individualist

Common Good Social Welfare Collectivism	Individual Initiative Individualism

Capitalism – The Disadvantages
•Consumers can be manipulated by advertising
•Prices and incomes might not reflect what is best for society
•Business cycle experiences many ups and downs (= considerable unemployment)
•Monopolies and oligopolies can emerge that charge unreasonable prices
•Extreme income inequality results
•Industry cost-cutting can lead to environmental problems
•Insecurity is present on a large scale
•Difficult to break out of cycle of poverty

Recession

(job losses, low wages, crisis situation)

What should we do?

- Laisse-faire Economics: Government should not intervene, the business cycle will figure it out.
- Keynesian Economics: government should intervene to increase spending, and put people back to work. Kick start the economy using government money as this will help people out during this time.
  - ✓ reduce taxes (fiscal relief)
  - ✓ increase government expenditures (public works projects to get people working)
  - ✓ low interest rates (encouraging people to spend their money)

What will this do?

increase purchasing power of citizens

↓

renewed spending

↓

encourage production of goods and services

↓

employment will rise

↓

citizens will have additional $ to spend and put back into the economy

↓

economy fixed!

Recovery

(Unemployment decreases, wages SLOWLY rise, economy seems better)

What should we do?

- Laisse-faire Economics: Government should not intervene, the business cycle will figure it out.
- Keynesian Economics: Government should intervene to continue some spending and cut others slowly, to encourage the continued economic output.
  - ✓ taxes stay the same
  - ✓ small reduction in government expenditures
  - ✓ interest rates stay the same or slowly start to increase

Prosperity/Boom

(Low unemployment, high wages, prices are increasing)

What should we do?

- Laisse-faire Economics: Government should not intervene, the business cycle will figure it out.
- Keynesian Economics: Government should intervene: it need to cut spending and increase revenue and save money.
  - ✓ taxes increase
  - ✓ reduction in government expenditures; government starts saving for the next recession
  - ✓ interest rates begin to increase

Inflation

(prices are too high!)

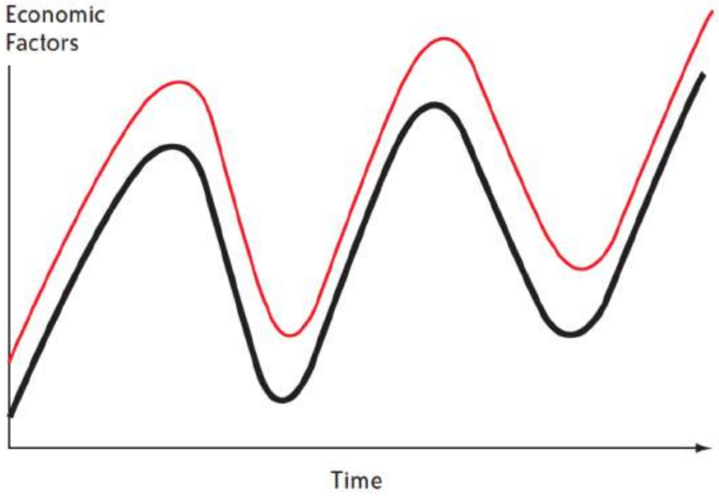
What should we do?

- Laisse-faire Economics: Government should not intervene, the business cycle will figure it out.
- Keynesian Economics: Government should intervene to slow down the economy
  - ✓ increase taxes
  - ✓ reduction in government expenditures
  - ✓ increase interest rates

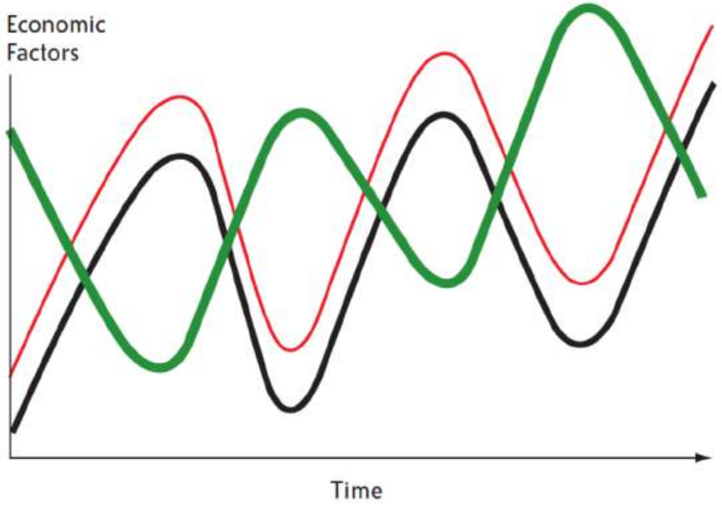
Important to Note

- Keynesian Economics "wins" during the depression and post WWII, so many countries and governments follow its principles… sort of.
- Remember, you have to increase taxes and cut spending during an economic boom – but any government that tries that gets voted out of office…so governments keep spending and spending and spending. Huge debt, and inflation is not regulated.
  - This becomes a HUGE problem in England and the US during the 1970 –(more on this later in our journey through economic history)
- Keynesian economics was the popular thing to do – so everyone did it; all the economists who were sounding alarms and arguing against this were ignored.

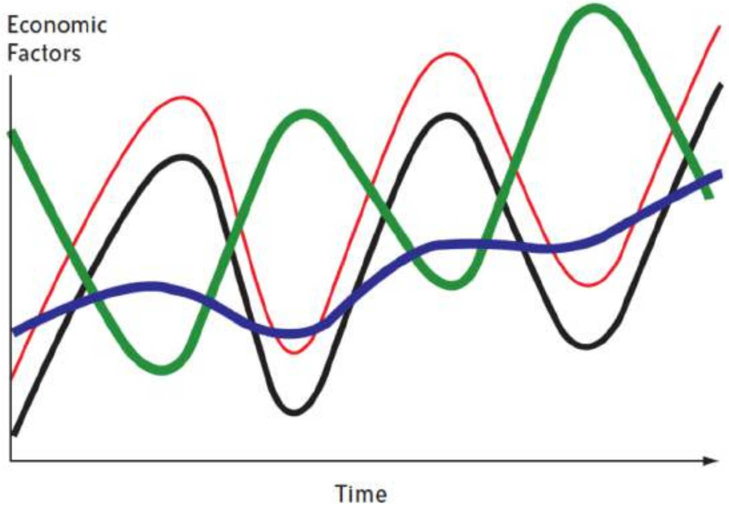
Business Cycle Before Government Intervention



How Keynes Suggested that Government Intervene



Anticipated Result of Government Intervention



- "Boom and Bust" cycle of the free-market economy
- Taxes collected by government (as a result of people's earnings and spending in the free-market economy)
- Government spending (for example, on infrastructure or social programs)
- Desired result: gradual growth and decline in the economic cycle, as opposed to the great variations of the "boom-bust" cycle

Supply Side Economics

Supply-side economics is a macroeconomic theory arguing that **economic** growth can be most effectively created by lowering taxes and decreasing regulation, by which it is directly opposed to **demand-side economics**.

This is also know as trickle-down economics - government economic policies that include reduced income and business taxes, reduced regulation (controls on business), and increased government spending on the military. Generally these policies favour industry, assuming that if industry prospers then everyone will prosper as wealth “trickles down” to the ordinary workers and consumers.

Friedrich Hayek

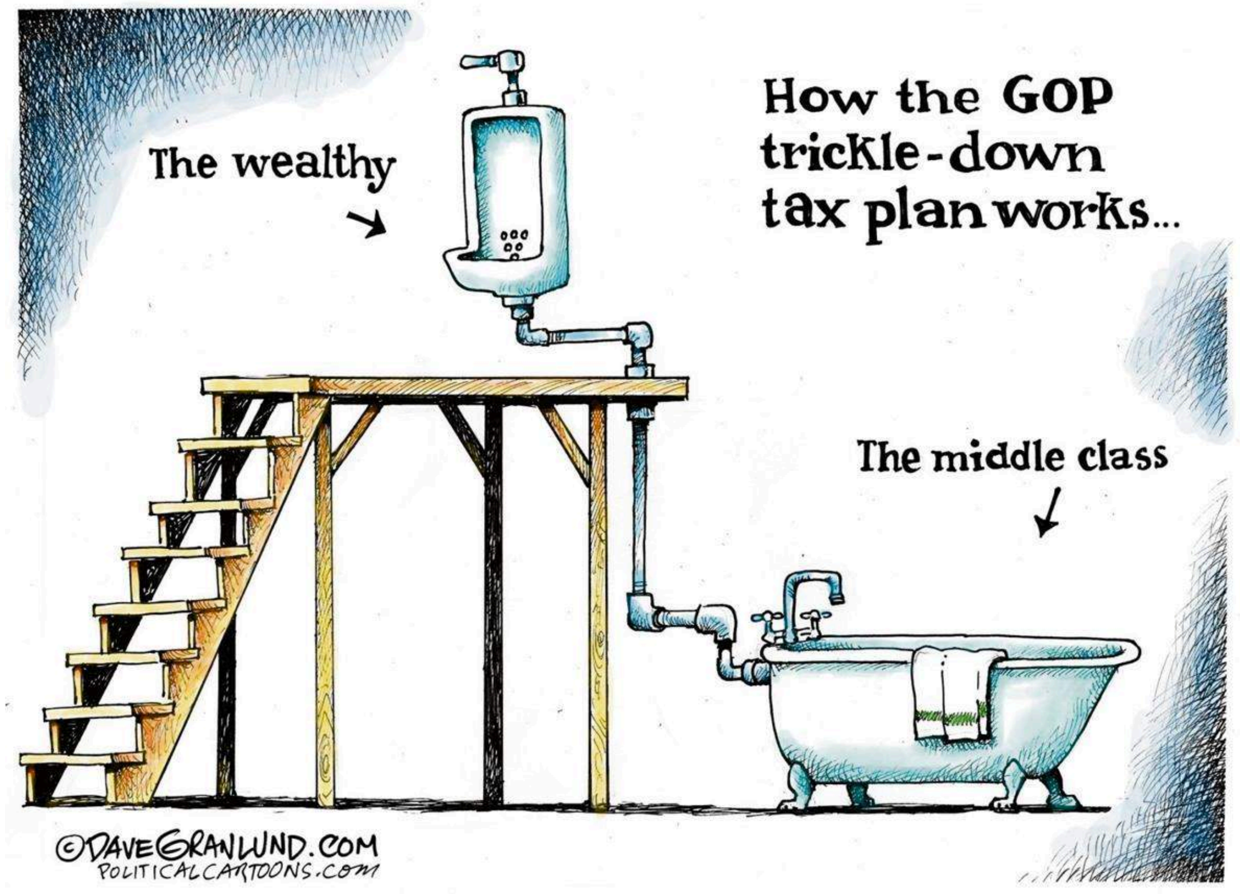
Friedrich Hayek was an Austrian-British economist and philosopher best known for his defence of classical liberalism.

His theory on how changing prices relay information that helps people determine their plans is widely regarded as an important milestone achievement in economics.

Hayek believed that markets will heal themselves and that government should not intervene (vs. Keynes who believed that governments should intervene in order to soften the blow of a depression/recession.)

Trickle Down Economics

Supporters of this perspective maintain that by lowering tax rates, especially among those who are most likely to invest capital (that is, the wealthy), economic growth will be encouraged through increased investment. It was argued that the benefits of increased private investment and government defence spending would “trickle down” through the economy to the working class.



Recession

(job losses, low wages, crisis situation)

Government should stimulate the economy by:

- ✓ reducing corporate and personal taxes
- ✓ lowering interest rates
- ✓ privatizing government owned businesses (sell)
- ✓ reduce regulations (rules and paperwork)

What will this do?

Private sector produces more goods, hires more people

↓

employment levels increase, wages go up

↓

results in additional spending, and greater demand

↓

More people get hired to meet demand

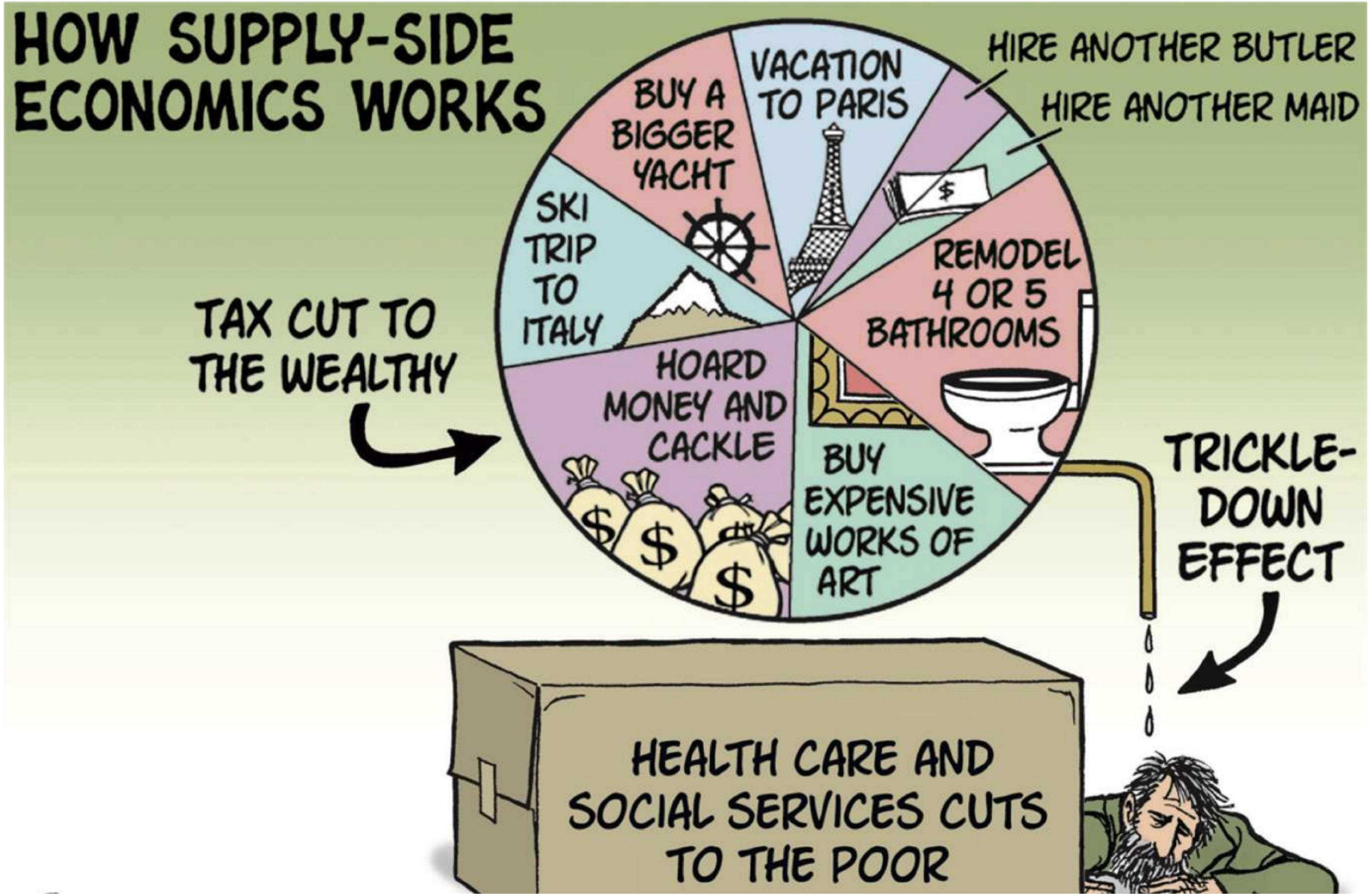
↓

economy fixed!

Inflation

(prices are too high!)

The unrestricted market will bring the economy under control or...monetarism (take money out of circulation).


HOW SUPPLY-SIDE ECONOMICS WORKS
BUY A BIGGER YACHT
VACATION TO PARIS
HIRE ANOTHER BUTLER
HIRE ANOTHER MAID
SKI TRIP TO ITALY
REMODEL 4 OR 5 BATHROOMS
TAX CUT TO THE WEALTHY
HOARD MONEY AND CACKLE
BUY EXPENSIVE WORKS OF ART
TRICKLE-DOWN EFFECT
HEALTH CARE AND SOCIAL SERVICES CUTS TO THE POOR