HL IB Economics

Your notes

3.7 Supply-Side Policies

Contents

3.7.1 An Overview of Supply-Side Policies

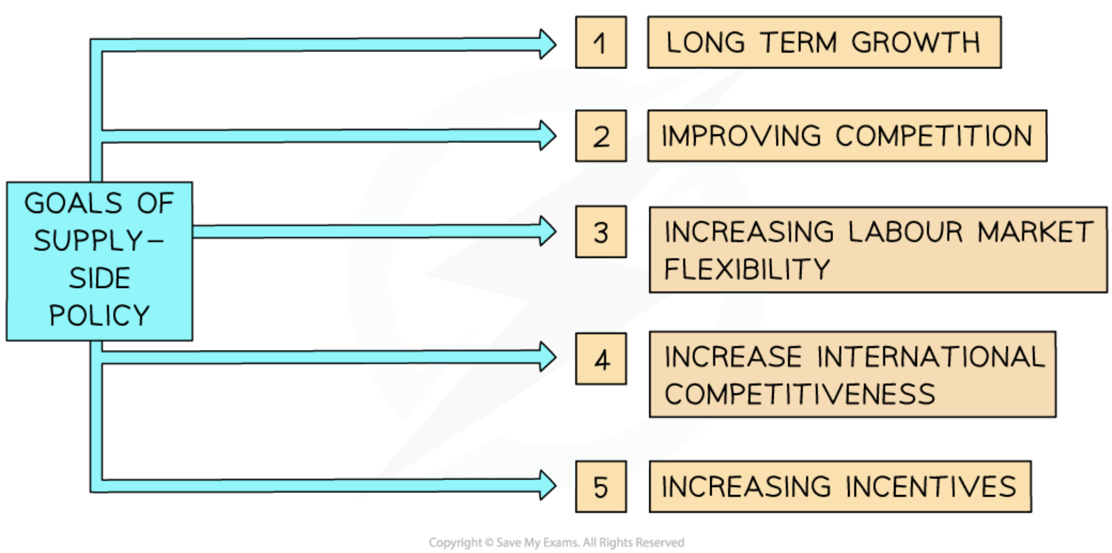
Your notes

Introduction to Supply-side Policy

- **Supply-side policies** aim to shift the long-run aggregate supply (LRAS)
- There are two categories of supply-side policies
  - **Interventionist** and **market-based**
- Interventionist supply-side policies require **government intervention** in order to increase the **full employment level of output**
  - These are mainly used to correct **market failure**
- **Market-based supply-side policies** aim to remove obstructions in the **free market** that are holding back improvements to the long-run potential
  - E.g. Setting up a regulator to **prevent monopolies** from forming

The Goals of Supply-side Policy

- Supply-side policies can be extremely useful in **generating long term growth**, lowering average price levels, and creating new jobs in an economy



Your notes

The five goals of Supply-side policy

- When successful, **supply-side policies** have the following effects on the **government's macroeconomic objectives**

1. **Economic growth:** potential national output increases leading to higher **real gross domestic product (rGDP)**
2. **Inflation:** a greater supply in the economy results in reductions in the prices of goods/services leading to **disinflation** and making the exports of the nation more competitive
3. **Unemployment:** this should fall as lower wage bills allow firms to recruit more workers
4. **Net external demand:** due to the increased supply, the prices of goods/services often decrease which makes them relatively more attractive to foreigners - so exports increase
5. **Redistribution of income:** this often worsens with the use of supply-side policies as wages fall and government tax revenue has fallen too

Market Based Supply-side Policies

- Market based supply-side policies aim to **free up markets** and improve market incentives so as to increase the long-run aggregate supply

An Explanation of Market Based Supply-side Policies

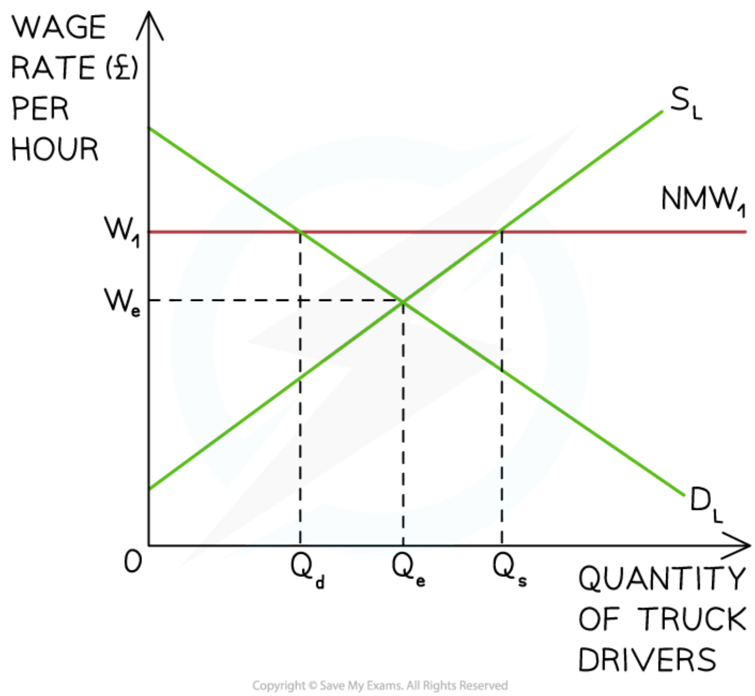
Market based policy	Explanation	Possible effects on the aims of supply-side policy
To increase incentives	▪ Reducing **income/corporation tax** rates incentivises workers to work harder (they keep more money for themselves) and provides firms with extra funds which they can use to invest in new machinery/technology ▪ Reducing **capital gains tax**	Taxes decrease → firms and individuals retain more money for themselves → incentives increase → productivity improves → long term growth increases
To improve competition and efficiency	▪ **Deregulation.** Any regulation increases costs of production for firms and deregulation decreases costs which may result in greater supply ▪ **Privatisation**. Government firms are usually so big that private enterprise refrains from trying	Regulation on firms decreases → the cost of production for firms falls → firms lower selling prices → international competitiveness improves

	to compete with them. Privatisation encourages new firms to enter the market and compete, thus increasing the **aggregate supply** in the economy ▪ **Anti-monopoly regulation** helps to increase competition in an economy which leads to a more efficient allocation of resources	State owned firms are privatised → more firms enter the market to compete → competition and efficiency improves
To reduce labour costs and create labour market flexibility	▪ Decreasing **trade union power** so wages can be decreased ▪ Decreasing or abolishing **minimum wages** to lower costs of production ▪ Restructuring the **unemployment benefits** system to incentivise the unemployed to seek work	Wages decrease → the cost of production for firms falls → firms lower selling prices → international competitiveness improves

The possible impact of abolishing minimum wages

- A **national minimum wage (NMW)** is a **legally imposed wage level** that employers must pay their workers
  - It is set **above** the market rate
  - Removing it will allow wage levels to fall, thus **reducing the costs of production** for firms

Your notes



Removing the national minimum wage (NMW_1) may cause wage rates to fall from W_1 to W_e

Diagram Analysis

- The **demand for labour (D_L)** represents the demand for workers by firms
- The **supply of labour (S_L)** represents the supply of labour by workers
- The **national minimum wage** and quantity for truck drivers in the UK is seen at **W_1Q_d**
- The UK government removes the **national minimum wage** (NMW) at **W_1**
- Incentivised by lower wages, the **demand for labour by firms increases** from $Q_d \rightarrow Q_e$
- Facing lower wages, the **supply of labour** by workers **decreases** from $Q_d \rightarrow Q_e$
- The labour market is now in equilibrium at W_eQ_e - a lower wage rate and higher quantity of workers employed

Interventionist Supply-side Policies

- Interventionist supply-side policies require **government intervention** in order to increase the **full employment level of output**

Your notes

An Explanation of Interventionist Supply-side Policies

Supply-side Policy	Explanation	Possible effects on the aims of supply-side policy
Education and training	▪ Increasing government spending on **education** and retraining raises the quality of the workforce resulting in productivity improvements	Skill level increases → productivity improve → the cost of production for firms falls → firms lower selling prices → international competitiveness improves
Improving quality, quantity and access to health care	▪ Increasing government spending on **healthcare** so that productivity improves	Human capital improves → productivity improves → the cost of production for firms falls → firms lower selling prices → international competitiveness improves
Research and development	▪ Increased **government spending** on innovation increases the supply of potential jobs in the economy	A new industry emerges → new infrastructure is developed → more jobs are created → r.GDP increases → increase in long term economic growth
Provision of infrastructure	▪ Increased government spending on infrastructure helps to facilitate the **movement of people and goods** which increases the aggregate supply	New infrastructure is developed → costs of production decrease → supply increases → firms lower selling prices → international competitiveness improves
Industrial policies	▪ Industrial policies are direct and targeted support to firms or industries in the form of **subsidies**	Industries receive subsidies → costs of production decrease → supply increases → firms lower selling prices → international competitiveness improves

EXAMINER TIP

Essay questions will test your ability to differentiate between market-based and interventionist supply-side policies.

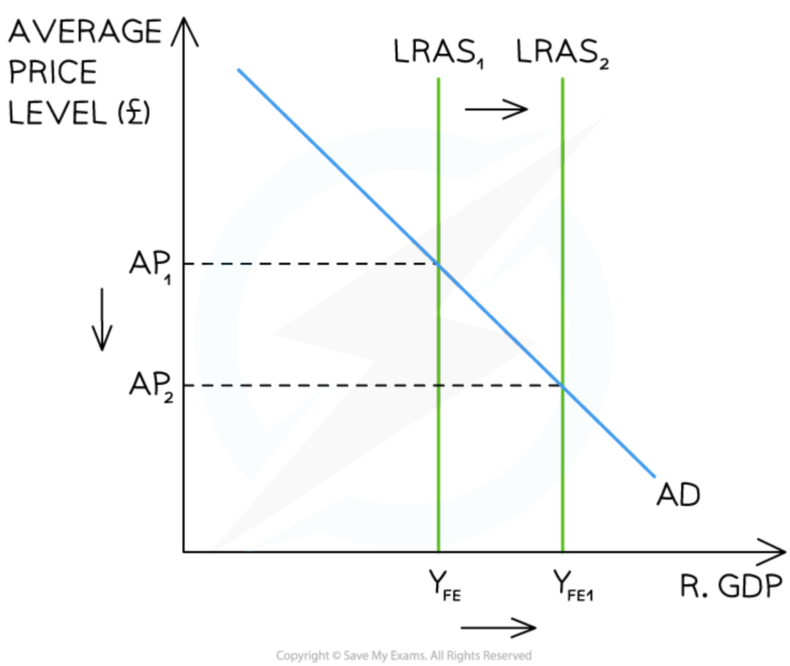
When evaluating supply-side polices in essay responses, demonstrate critical thinking by acknowledging that privatisation has been used for so long that there is often relatively few assets left to privatise and perhaps a better way forward is to improve competition policy and regulation.

Remember, the private sector will also be increasing supply in an economy (it is not only up to the government) as they are incentivised to increase their profits.

Your notes

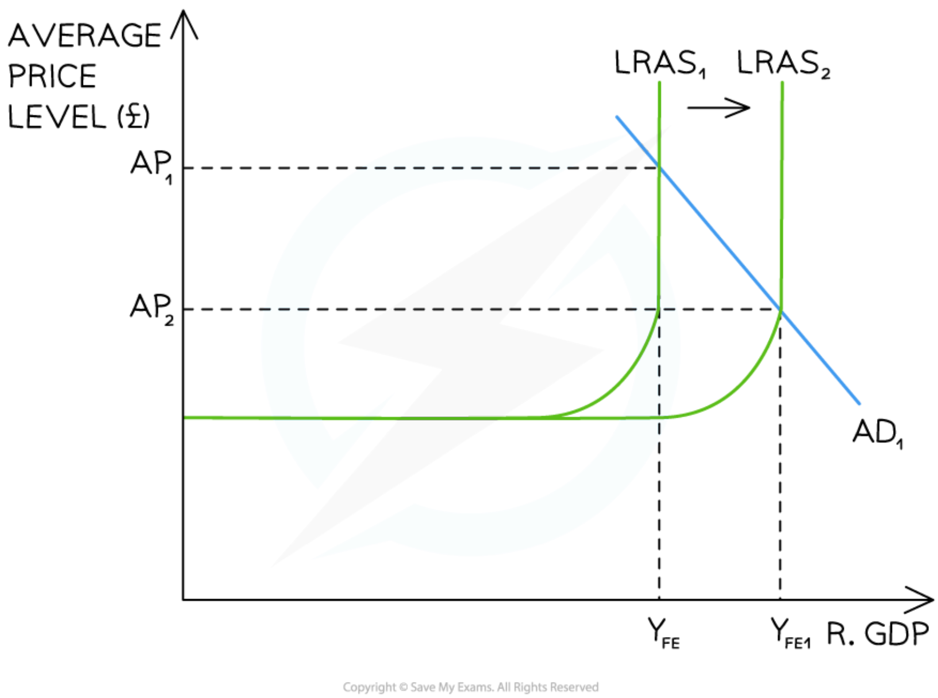
Diagrams to Illustrate Supply-side Policies

- Successful supply-side policies will increase the **long-run aggregate supply (LRAS)**
  - This equates to an increase in the production possibilities of an economy
- The successful implementation can be illustrated on either a **Classical or Keynesian** diagram



A Classical diagram that illustrates the implementation of a successful supply-side policy

Your notes



A Keynesian diagram that illustrates the implementation of a successful supply-side policy

Diagram Analysis

- Efforts to reduce **trade union power** have been successful
  - There is now less protection on wage levels and **wage levels fall**
- Firms may **hire more workers** and the **quantity of productive labour** in the economy has increased
  - This causes LRAS1 to increase to $LRAS_2$
    - **Output increases** from Y_{FE} to Y_{FE1}
    - Average **price levels** fall from $AP_1 \rightarrow AP_2$

3.7.2 The Effectiveness of Supply-Side Policies

Your notes

Demand-side Effects of Supply-side Policies

- Supply side policies aim to increase the **long-run aggregate supply**
- These policies often take years to complete, but once completed, they add extra **productive potential** to the economy
- Examples of these kinds of policies include building new roads, new airports, new ports, new hospitals, new schools, new hydroelectric dams etc.

- These types of supply-side policies require **government spending** on an annual basis for as long as it takes to complete the project
  - This government spending is a component of **aggregate demand** and helps to boost the national output in that year
  - E.g. to build a new port, the government has to hire a firm to complete the project, pay their workers, and pay for the materials (cement, sand, trucks, steel etc)
  - This government spending boosts aggregate demand in the short term
- It has been argued that **the best government spending** is that which boosts AD in the short term but increases LRAS in the long term

Supply-side Effects of Fiscal Policies

- Many **fiscal policies** have the ability to improve the **productive potential (supply-side)** of an economy
  - E.g. Education subsidies to help the poorest households constitute an annual expenditure for the government. However, in the long term they help to **improve human capital** which boosts productivity and output
  - The fiscal policy is short term (annually) however the supply-side impact occurs in the long term

An Evaluation of Supply-side Policy

- The benefits of supply-side policies far **outweigh the negatives**, yet many economies fail to fully develop their supply-side policies due to a process of constant political change - and an associated change in government priorities

An Evaluation of Market Based Supply-side Policies

Your notes

Advantages	Disadvantages
▪ **Improved resource allocation:** increasing the productive capacity of an economy requires more efficient use of its resources, including labour ▪ **No burden on government budget:** with an emphasis on freeing up markets and allowing market forces to drive efficiency and resource allocation, there is no requirement for government spending	▪ **Equity issues:** E.g. the distribution of income worsens as labour market reforms and wage policies lower worker's wages ▪ **Time lags:** there are significant time lags between expenditure and seeing the benefits ▪ **Vested interests:** can result in less effective outcomes e.g. there are many examples of privatisation occurring in such a way that the government's preferred bidders obtained an **asset at a knock down price** ▪ **Environmental impact:** large infrastructure projects almost always have some negative externalities associated with their creation e.g. dam in a gorge to create a hydro electric dam damages the natural environment and eco system

An Evaluation of Interventionist Supply-side Policies

Advantages	Disadvantages

▪ **Direct support of sectors important for growth:** Subsidies to specific industries increase the rate of growth of an economy
  ▪ Direct support reduces unemployment
  ▪ Direct support can increase the level of exports
▪ **Improvements in living standards:** Improvements in Infrastructure can raise the quality of life for all citizens
	▪ **Costs:** **t**hey are expensive to implement and are paid for using tax revenue - or increased government borrowing
	▪ Time lags: due to the long-term nature, **changes in government** often result in changes to budgets and scope of projects and the end result may be **less effective** than it could have been