Edexcel (B) Economics A-level

Theme 4: Making Markets Work

4.4 Macroeconomic Policies and Impact on Firms and Individuals

4.4.3 Supply-side policies

Notes

Distinction between market-based and interventionist methods

Supply-side policies aim to improve the long run productive potential of the economy. The economy can experience **supply-side improvements** in the private sector, without government intervention. For example, there could be improvements in productivity, innovation and investment. The aims of supply-side policies include:

Strengths and weaknesses of supply-side policies:

- Supply-side policies are the only policies which can deal with structural unemployment, because the labour market can be directly improved with education and training.
- Demand-side policies are better at dealing with cyclical unemployment, since they can reduce the size of a negative output gap and shift the AD curve to the right.
- There are significant time lags associated with supply-side policies.
- Market-based supply-side policies, such as reducing the rate of tax, could lead to a more unequal distribution of wealth.

The distinction between market-based and interventionist policies:

Market-based policies limit the intervention of the government and allow the free market to eliminate imbalances. The forces of supply and demand are used.

Interventionist policies rely on the government intervening in the market.

Free market supply-side policies

- **To increase incentives**
  - Reducing income and corporation tax to encourage spending and investment. This could increase the long run productive potential of the

economy, especially if labour and capital becomes more productive. This improves the underlying trend of economic growth.

- **To promote competition**
  - By deregulating or privatising the public sector, firms can compete in a competitive market, which should also help improve economic efficiency.
- **To reform the labour market**
  - Reducing the NMW (or abolishing it altogether) will allow free market forces to allocate wages and the labour market should clears. Reducing trade union power makes employing workers less restrictive and it increases the mobility of labour. This makes the labour market more efficient.

Interventionist supply-side policies:

- **To promote competition**
  - A stricter government competition policy could help reduce the monopoly power of some firms and ensure smaller firms can compete, too.
- **To reform the labour market**
  - Governments could try and improve the geographical mobility of labour by subsidising the relocation of workers and improving the availability of job vacancy information.
- **To improve skills and quality of the labour force**
  - The government could subsidise training or spend more on education. This also lowers costs for firms, since they will have to train fewer workers.
  - Spending more on healthcare helps improve the quality of the labour force, and contributes towards higher productivity.
- **To improve infrastructure**
  - Governments could spend more on infrastructure, such as improving roads and schools.

The use of AD/AS diagrams to illustrate supply-side policies

Both diagrams show the effects of employing a supply-side policy. The LRAS curve shifts to the right, to show the increase in the productive potential of the economy. In other words, the maximum output of the economy at full employment has increased. This leads to a fall in the average price level, from P1 to P2, and an increase in national output, from Y1 to Y2.

The first diagram is the Keynesian LRAS curve, and the second is the Classical LRAS curve.