WJEC (Wales) Economics A-level

Macroeconomics

Topic 3: Policy Instruments

3.5 Supply side policies

Notes

Supply-side policies aim to improve the long run productive potential of the economy. This increases the quantity or quality of the factors of production.

Education and training

The government could subsidise training or spend more on education. This also lowers costs for firms, since they will have to train fewer workers. It makes the quality of labour better, which results in a more productive workforce. This increases the potential output of an economy.

By improving access to training and education, it becomes more convenient for people to improve their skills, which is likely to encourage them to do so. For example, universities might use access schemes to encourage more people to apply, or apprenticeships might become more widely available.

Reforming tax and benefits, or reducing marginal tax rates

By reducing income and corporation tax, governments could encourage spending and investment.

Tax reforms could encourage more people to work, and benefits could be more stringent. They can also encourage more entrepreneurship.

Improving labour market flexibility- including consideration of the housing market

Reducing the National Minimum Wage (or abolishing it altogether) will allow free market forces to allocate wages and the labour market should clear.

Governments could try and improve the geographical mobility of labour by subsidising the relocation of workers and improving the availability of job vacancy information.

Working arrangements could be made more flexible.

Immigration

Migration can fill skills gaps and reduce the unemployment rate. This could result in higher productivity among the labour force.

Privatisation and deregulation

By deregulating or privatising the public sector, firms can compete in a competitive market, which should also help improve economic efficiency.

Trade union reform

Reducing trade union power makes employing workers less restrictive and it increases the mobility of labour. This makes the labour market more efficient.

Infrastructure development- including consideration of transport market

Governments could spend more on infrastructure, such as improving roads and schools. This could make transport more efficient, since it will take less time and cost less to move between places. It might also contribute to the geographical mobility of labour.

Research and development incentives

This can encourage more investment, which can benefit the economy in the long run by helping firms find more efficient methods of production and innovating.

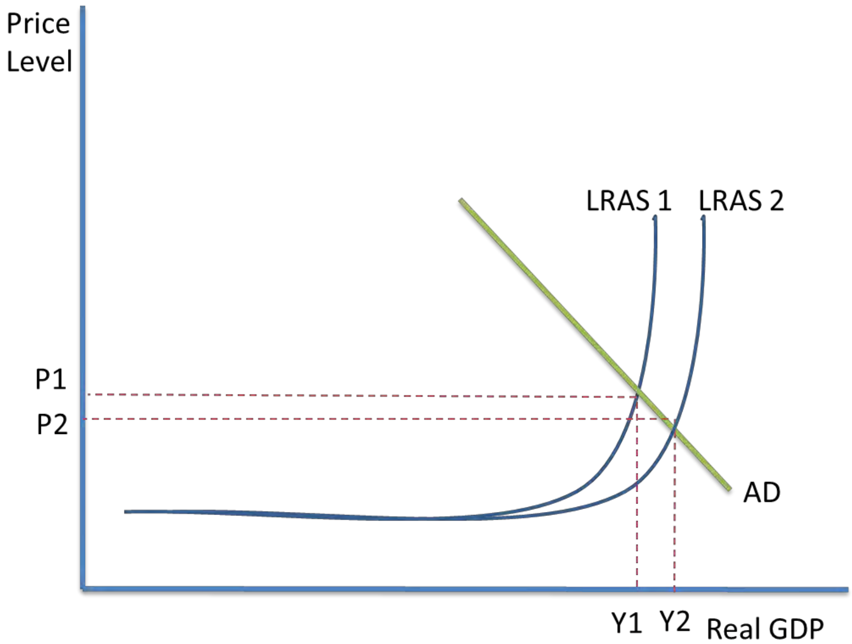
Subsidies

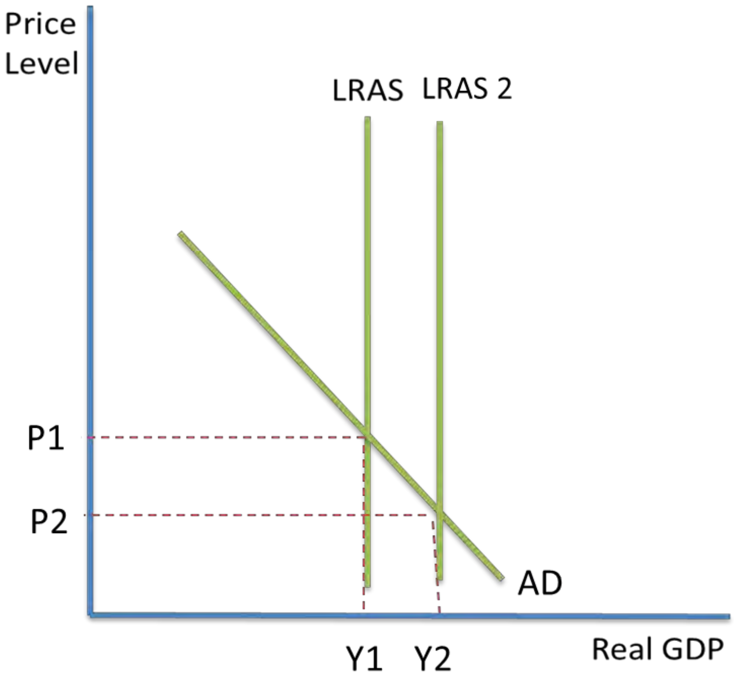
These could be directed towards small businesses to encourage them to expand, or to lower training costs for firms.

AD/AS diagrams:

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.


Price Level
LRAS 1
LRAS 2
P1
P2
AD
Y1
Y2
Real GDP


Price Level
LRAS
LRAS 2
P1
P2
AD
Y1
Y2
Real GDP

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- **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.

- Some supply-side policies, such as reducing the rate of tax, could lead to a more unequal distribution of wealth.