OCR Economics A-level

Macroeconomics

Topic 3: Implementing Policy

3.3 Supply-Side Policy

Notes

Supply-side policies are government policies aimed at **increasing the productive potential of the economy** and moving the supply curve to the right. Over time, there tend to be supply-side improvements independent of the government, through actions of the private sector such as investment. However, the government is able to use supply-side policies in order to increase and speed up these improvements. They may be across the whole economy or in certain markets to target economic growth in that sector.

- There are two types of supply-side policies:
    - ➔ **Market-based** - policies designed to allow the free market to work efficiently by removing any barriers to entry.
    - ➔ **Interventionist** - policies designed to correct *market failures*, whereby the free market fails to allocate resources efficiently.

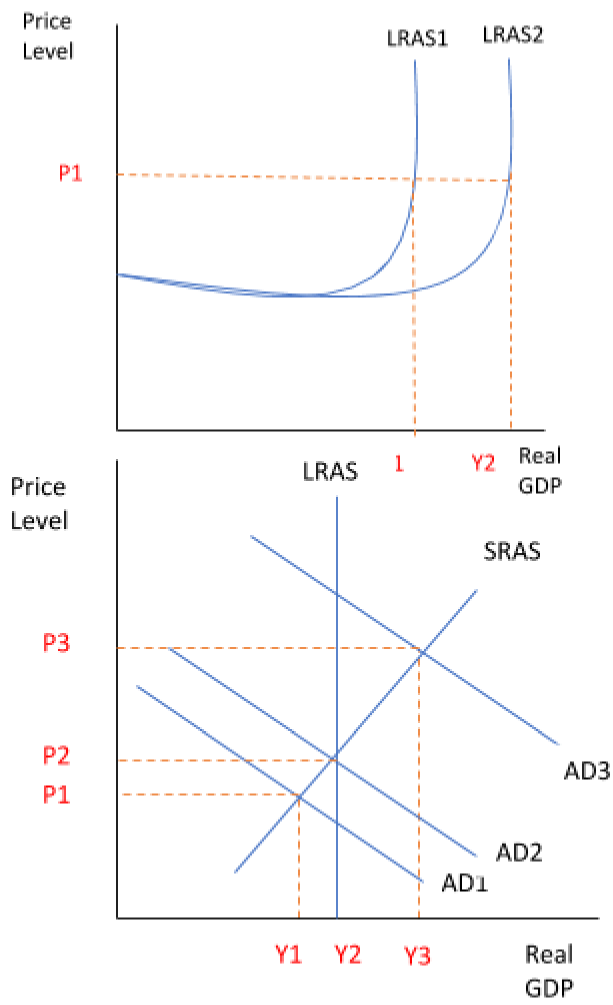
1. Interventionist Policies

- The main interventionist policy used as AS and A-level is government spending on **training and education** (T&E). N.b. this is government investment in *human capital*.
- E.g. the UK government spent £400 million on schools in 2019, and plan to increase teachers' salaries to £30,000.

Effects on economic growth:

- Training and Education results in more skilled - and therefore **productive** - workers. An increase in productivity means an economy is producing more output with the same level of input, and therefore shifts the LRAS curve to the right. As shown, this increases output from Y1 to Y2,

- In addition, as government spending is a component of aggregate demand, the AD curve also shifts to the right. As explained in previous notes, according to the multiplier effect an initial injection in the circular flow of income results in a proportionally larger increase in national output, as shown on the diagram. However, this assumes P3 doesn't exceed the Monetary Policy Committee's target of 2.0% inflation, else there will be a conflict of macroeconomic objectives.

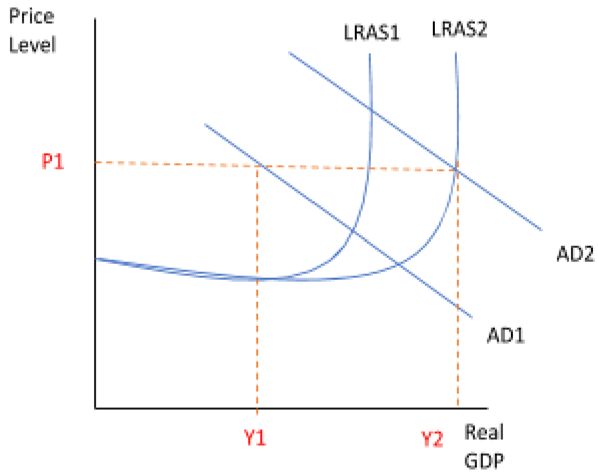


Effects on unemployment:

- As explained above, because government expenditure leads to a boost in aggregate demand, there is an initial reduction in the unemployment rate, as labour is a **derived demand**, so more workers will be required to help businesses cope with the surge in consumer demand. This type of unemployment is referred to as **cyclical unemployment**.

- As workers are equipped with a variety of skills, this eliminates problems associated with **occupational immobility**, whereby workers are unable to switch jobs due to a mismatch between the skills workers have and the skills firms require. This type of unemployment is referred to as **structural unemployment**.

Effects on inflation:



- Even though T&E shifts the demand curve to the right, the **inflationary effects** are eliminated by the outward shift of the LRAS curve. However, this assumes both curves shift outward by the same amount, which in a real-world scenario may not be the case.

- An alternative argument economists make is that prices fall rather than raise. This is because, as firms experience a surge in demand, they can exploit **economies of scale** (see notes), whereby the average costs fall as more output is produced. As costs are usually passed onto consumers in prices, lower costs will translate to lower consumers prices.

Effects on the current account:

- If we were to follow the second argument above (regarding the fall in consumer prices), then goods and services in the UK would become more price competitive relative to other countries. If the price of a good is lower in the UK than France, for example, then french consumers are more likely to **import** from the UK. If the economy experiences more exports then, assuming the level of imports remains constant or decreases, the current account **deficit** is reduced by definition.

- Government spending on training and education would also improve the state of the **financial account**, because economic growth has historically translated to more **Foreign Direct Investment** (FDI), as foreign firms are attracted by the higher profit margins and domestic demand.

Evaluating Training and Education:

- There is a **time-lag** with this particular approach, e.g. it takes at least 7 years for a doctor to be fully trained at university. Therefore, this policy should not be used for issues that need to be fixed immediately.
- Spending on T&E is **relative** to other countries. For example if the quality of education is poor in the UK and high in Germany, then investing in T&E won't necessary make the price of goods and services lower than in Germany, as there may still be a significant difference in the quality of education between the two countries.
- This applies to most theories put forward by economists, but the T&E argument assumes "**ceteris paribus**" ('all other things being equal'). However, in a real-world scenario an economy is prone to external shocks, for example in 2020 the covid-19 pandemic disrupted global supply chains and sent the majority of nations into recessions. Therefore investing in T&E wouldn't yield the outcomes described in the page above.

2. Market-based policies

- One way of promoting supply-side growth is by reducing **corporation** and **income** tax.
- Another policy, that gives the same economic effects, is **privatisation** (the transfer of assets from the public sector to private ownership).
- An alternative market-based supply-side policy is **deregulation**, whereby firms cut down on **red tape** and reduce barriers to entry to allow new entrants to join the market.

Effects of privatisation and tax reduction:

- As firms become private, there is an increase in competition and **efficiency** due to the presence of a profit motive. In addition, as taxes are usually passed onto consumers in the form of higher prices, by reducing corporation tax, consumers will experience lower prices. Therefore, if the two policies are combined, there will be an overall reduction in the **inflation rate**, which could help maintain the MPC's target of 2.0% inflation.
- Privatisation helps reduce the government's **structural budget deficit** (see notes), as private investors must pay a large fee in order to gain ownership of the firm turning private. This private firm must then contribute to government tax revenues.

Effects of deregulation:

- By allowing firms to function more freely, there is potential for productivity to increase, which would in turn reduce prices for consumers, helping to achieve the 2.0% target and improve **economic welfare**.