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Economics Revision Focus: 2004

AS Economics

Supply Side Economic Policies

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Revision Focus on Supply Side Economic Policies

AS Syllabus Requirements:

Supply-side Policies

Candidates should understand the role of supply-side policies in influencing the **underlying trend rate of economic growth** and the potential output of the economy and their contribution in reducing unemployment, inflation and improving the balance of payments

What are supply-side policies?

Supply-side economic policies are mainly **micro-economic policies** designed to improve the supply-side potential of an economy, make markets and industries operate more efficiently and thereby contribute to a **faster rate of growth of real national output**

Most governments now accept that an improved supply-side performance is the key to achieving **sustained economic growth without a rise in inflation.** But supply-side reform on its own is not enough to achieve this growth. There **must also be a high enough level of aggregate demand** so that the productive capacity of an economy is actually brought into play.

There are two broad approaches to the supply-side. Firstly policies focused on **product markets** (where goods and services are produced and sold to consumers) and secondly the **labour market** – a factor market where labour is bought and sold.

Supply Side Policies for Product Markets

Product markets refer to markets in which all kinds of commodities are traded, for example the market for airline travel; for mobile phones, for new cars; for pharmaceutical products and the markets for financial services such as banking and occupational pensions.

Supply-side policies in product markets are designed to **increase competition** and **efficiency**. If the **productivity** of an industry improves, then it will be able to produce more with a given amount of resources, shifting the LRAS curve to the right.

Privatisation

Over the last twenty-five years, many former state-owned businesses have been privatised – i.e. they have transferred from the public sector into the private sector. Examples in Britain include British Gas, British Telecom, British Airways, British Steel, British Aerospace, the regional water companies, the main electricity generators and distributors, and the Railways. British Rail was privatised in 1994 but the failure of Railtrack led to the creation of Network Rail, a 'not for profit' company in 2002. The Labour Government has continued to privatise or part-privatise other parts of the UK public sector since it came to power in 1997.

Privatization is designed to break up state monopolies and create more competition. The government also created utility regulators who have imposed price controls on many of these industries and who are now over-seeing the move towards competitive markets in areas such as gas and electricity supply and telecommunications.

Deregulation of Markets

De-regulation or **liberalisation** means the **opening up of markets to greater competition.** The aim of this is to **increase market supply** (driving prices down) and widen the **range of choice available to consumers.** The discipline of competition should also lead to **greater cost efficiency** from producers – who are keen to hold onto their existing market share. Good examples of deregulation to use include: urban bus transport, parcel delivery services, mortgage lending, telecommunications, and gas and electricity supply.

Toughening up of Competition Policy

Most supply-side economists believe in the **dynamic effects of greater competition** and that competition forces business to become more efficient in the way in which they use scarce resources. This reduces costs which can be passed down to consumers in the form of lower prices. A tougher competition policy regime includes policies designed to curb anti-competitive practices such as **price-fixing cartels** and other abuses of a dominant market position – in other words – intervention to curb some of the market failure that can come from monopoly power

A commitment to free international trade

Trade between nations creates competition and should be a catalyst for improvements in costs and lower prices for consumers. The UK government is committed to an expansion of free trade within the European Single Market and also to negotiating a liberalisation of trade in the global economy as part of its membership of the World Trade Organisation. For example, it wants to see further reforms of the Common Agricultural Policy as a stepping-stone to global trade agreements between Europe, the United States and developing countries.

Measures to encourage small business start-ups / entrepreneurship

The small businesses of today can often become the larger businesses of tomorrow, adding to national output, employing more workers and contributing to innovative behaviour that can have positive spill-over effects in other industries. Governments of all political persuasion argue that they want to **promote an entrepreneurial culture** and to **increase the rate of new business start-ups.** Supply side policies include loan guarantees for new businesses; regional policy assistance for entrepreneurs in depressed areas of the country; advice for new firms

Capital investment and innovation:

Capital spending by firms adds to aggregate demand (C+I+G+(X-M)) but also has an important effect on long run aggregate supply. Supply side policies would include tax relief on research and development and reductions in the rate of corporation tax. Ireland is a good example of a country inside the European Union that has benefited hugely from cutting company taxes which has led to a large rise in foreign direct investment. One of the new countries joining the EU in 2004, Estonia, has cut its corporation tax rate to zero per cent (0%) in a deliberate attempt to attract new investment and stimulate economic growth and employment. There are now big differences in corporation tax rates among the twenty five nations of the European Union.

Corporate tax rates in the European Union in 2004

Estonia	0.0%	Luxembourg	30.0%
Ireland	12.5%	Denmark	30.0%
Lithuania	15.0%	Czech Rep.	31.0%

Cyprus	15.0%	Portugal	33.0%
Latvia	19.0%	Austria	34.0%
Slovakia	19.0%	Belgium	34.0%
Poland	19.0%	Italy	34.0%
Hungary	20.0%	Netherlands	34.5%
Slovenia	25.0%	Spain	35.0%
Sweden	28.0%	Greece	35.0%
Finland	29.0%	France	35.4%
UK	30.0%	Germany	38.7%

The issue of incentives is crucial for if inventions and innovations can be widely and easily copied and implemented, then the rewards to those engaged in cutting-edge research might be diluted leading to a decrease in the willingness of entrepreneurs to take risks.

Supply side policies for the Labour Market

These policies are designed to improve the quality and quantity of the **supply of labour** available to the economy. They seek to make the British labour market more **flexible** so that it is better able to match the labour force to the demands placed upon it by employers in expanding sectors thereby reducing the risk of structural unemployment. An expansion in the UK's total labour supply increases the productive potential of an economy.

Trade Union Reforms

Many of the traditional legal protections enjoyed by the trade unions have been taken away – including restrictions on their ability to take industrial action and enter into restrictive practices agreements with employers. The result has been a decrease in strike action in virtually every industry and a significant improvement in industrial relations in the UK.

Increased Spending on Education and Training

Investment in education has the potential to **raise the skills within the work force** and improve the employment prospects of unemployed workers. Government spending on education and training improves workers' **human capital.**

Improved training should improve the **occupational mobility of workers** in the economy. This should help **reduce the problem of structural unemployment.** A well-educated workforce also acts as an **attraction for foreign investment** in the economy.

Income Tax Reforms and the Incentive to Work

Economists who support supply-side policies believe that lower rates of income tax provide a short-term boost to demand, and they improve incentives for people to work longer hours or take a new job – because they get to keep a higher percentage of the money they earn.

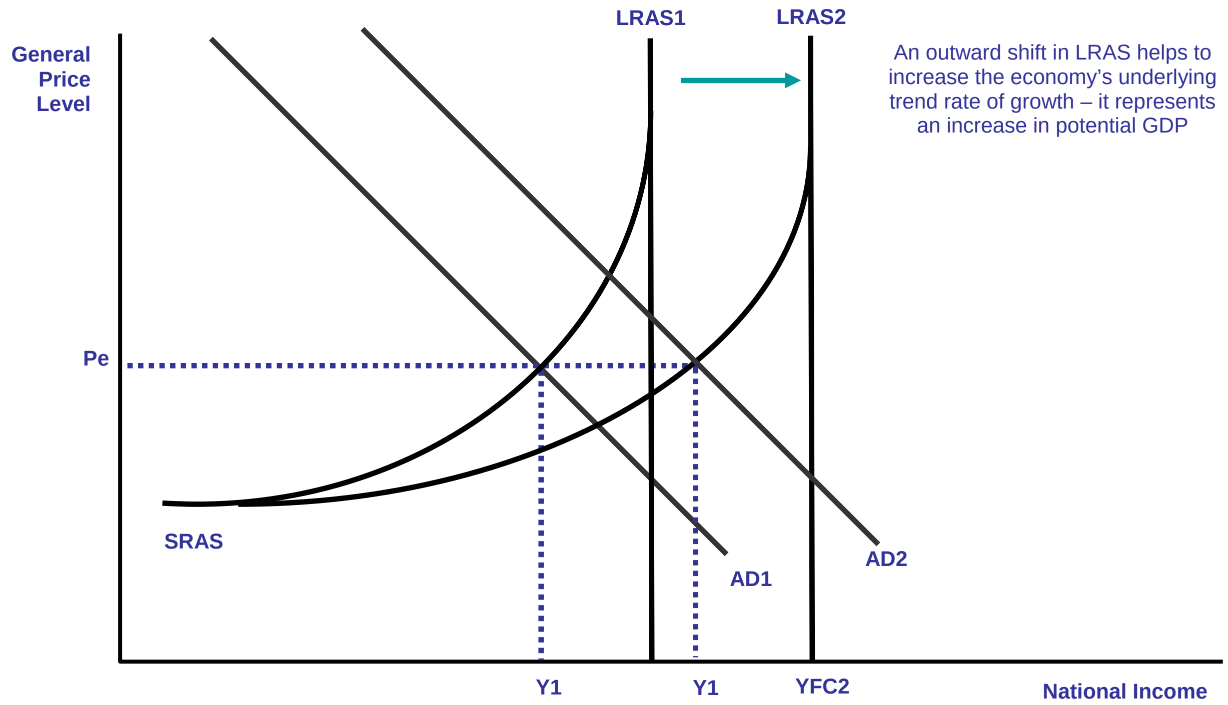
Attention has focused in recent years on lower income households. In the mid 1990s, a lower starting rate of tax of 10% was introduced and the band of income on which this is paid has been widened in recent Budgets. Cutting tax rates for lower paid workers may help to reduce the extent of the 'unemployment trap' – where people calculate that they may be no better off from working than if they stay outside the labour force.

Do lower taxes really help to increase the active labour supply in the economy? It seems obvious that lower taxes should boost the incentive to work because tax cuts increase the reward from a job. But some people may choose to work the same number of hours and simply take a rise in their post-tax income! Millions of other workers have little choice over the hours that they work.

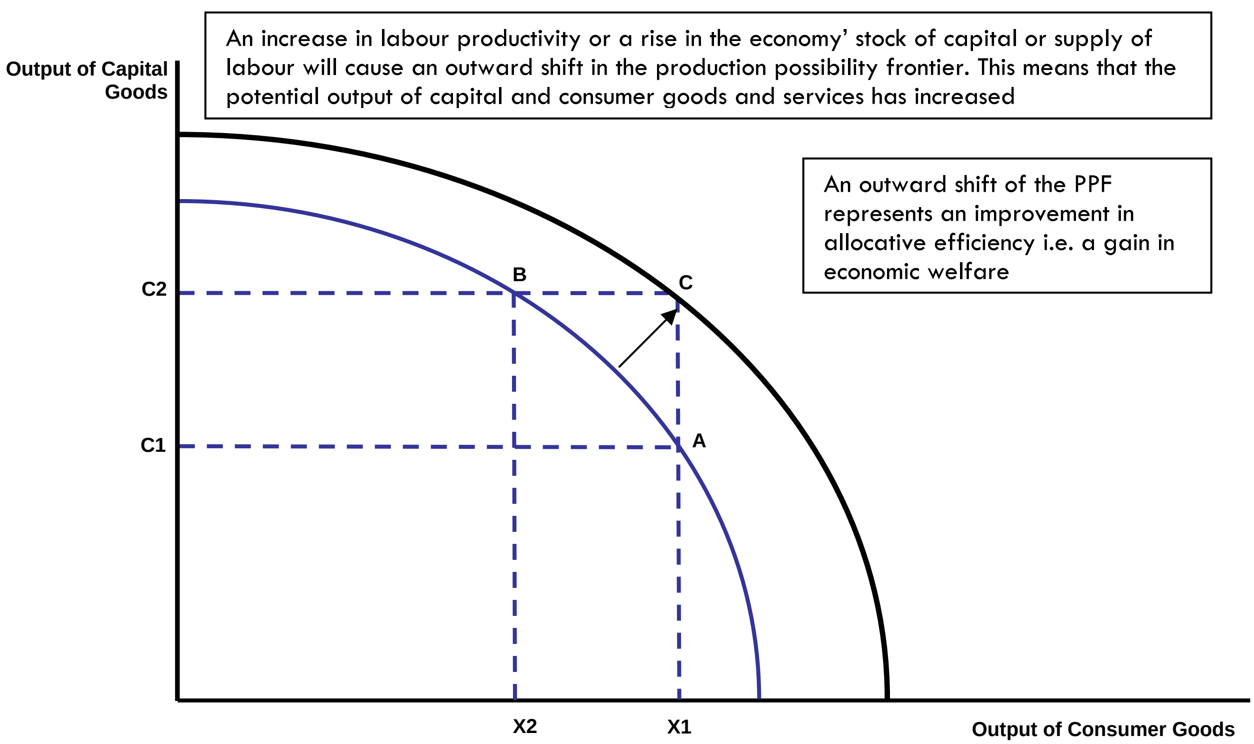
International Economy – Importance of the Supply-side

Supply-side factors often help to explain why it is that some countries grow faster than others. In a world of **globalisation,** it is becoming clearer that maintaining and improving **competitiveness** is vital in achieving success in international markets. A rising share of GDP in most countries is devoted to international trade. Markets are becoming more competitive and those countries whose supply-side lets those down can find a rising level of import penetration into their domestic markets and a weak export performance in goods and services.

Showing the effects of supply-side improvements in the economy



Supply side improvements can also be shown using a production possibility frontier



Supply and demand are linked!

It is important to recognise that **the supply-side does not operate in isolation from changes in aggregate demand**. If there is insufficient AD, it is unlikely that better supply-side performance can be achieved over a number of years. Equally, if aggregate demand grows too quickly, acceleration in wage and price inflation might require deflationary policies that ultimately harm a country's productive potential.