Supply-side policies

RIDLEY COLLEGE
SINCE 1889

Assessment Objectives

Specific Expectations	
4.A	Explain (using graphs as appropriate) public policies aimed at influencing long-run economic growth.
4.A	Define supply-side fiscal policies.

Supply-Side Policies

- **Supply-side policies** are a variety of policies focused on aggregate supply, namely factors aiming to shift the long-run aggregate supply curve (LRAS) to the right, in order to achieve long-term economic growth.
  - They do not attempt to stabilize the economy (to reduce the severity of the business cycle).
  - Supply-side policies increase productivity and reduce production costs, shifting SRAS and LRAS outward, increasing actual and potential output.
  - There are two major categories of supply-side policies: **market-based** and **interventionist**.
    1. **Market-based supply-side policies** are intended to reduce government intervention thereby allowing the free market to increase efficiency and improve incentives

Supply-Side Policies

2. **Interventionist supply-side policies** are government led attempts to increase the productive capacity of the country.

- The goals of supply-side policies include the following:

  1. **Promote long-term growth by increasing the productive capacity of the economy:** the main objective is to increase potential output, shown by a steeper long-term growth trend in the business cycle diagram, or a rightward shift of the LRAS curve.

  2. **Improve competition and efficiency:** the objective is to make the economy more responsive to the market forces of demand and supply so as to increase efficiency in production.

  3. **Reduce costs of labour and reduce unemployment through greater labour market flexibility:** greater labour market flexibility means making the labour market more responsive to the market forces of demand and supply so as to reduce unemployment as well as labour costs.

Supply-Side Policies

4. **Increase incentives of firms to invest in innovation by lowering costs of production:** higher after-tax profits through lower costs of production as well as lower taxes provide firms with incentives to engage in research and development that increase the productive capacity of the economy resulting in greater increases in productive capacity and growth in potential output.

5. **Reduce inflation to improve international competitiveness:** increase in potential output reduce inflationary pressures in the economy, thus making exports more competitive in global markts.

Market-based Supply-Side Policies

- **Market-based Supply-side policies** any policy based on promoting well-function, competitive markets in order to influence the supply-side of the economy, usually to shift the LRAS curve to the right, increased potential output and achieve long-term economic growth.
  - **Market-based supply-side policies** can be grouped under:
    1. **Encouraging competition:** greater competition among firms forces them to reduce costs, contributing to greater efficiency in production and improving resource allocation.
    2. **Labour market reforms:** are intended to get rid of rigidities by making labour markets more competitive, making wages respond to the forces of supply and demand, lowering labour costs and increasing employment by lowering the natural rate of unemployment.
    3. **Incentive-related policies:** involve cutting various type of taxes, while are expected to change the incentives faced by taxpayers, whether consumers firms of consumers.

Supply-side policies: Encouraging Competition

- Greater competition among firms has the possible added benefit of improving the quality of goods and services.
- These benefits will allow potential output to increase and the LRAS curve to shift to the right.

1. **Privatization:** involves transferring ownership of a firm from the pubic sector to the private sector, can increase efficiency due to improved management and operation of the privatized firm.
2. **Deregulation:** involves the elimination or reduction of government regulation of private sector activities, based on the argument that government regulation stifles competition and increases inefficiency.
   - **Economic regulation** involves government control of prices, output and other activities if firms, offering them protection against competition.
   - **Social regulation** involves protecting consumers against undesirable effects of private sector activities (negative externalities).

Supply-side policies: Encouraging Competition

3. **Contracting out to the private sector:** this is a policy option whereby governments make a contractual agreement with private firms to provide goods and services for the government.
   - These result in increased competition as private firms compete with each other to get contracts with the government.
4. **Anti-monopoly regulation** increased competition can result from restricting market power of firms by anti-monopoly legislation.
   - Breaking-up large firms that have been found to engage in monopolistic practices into smaller units that will behave more competitive
   - Preventing mergers that might result in too much market power.
   - Greater scope for the forces of supply and demand may result in increased efficiency, lower costs and improved quality.
5. **Trade liberalization:** free or freer trade increases competition between firms both domestically and globally, which can result in greater efficiency in production and an improved allocation of resources.

Supply-side policies: Labour Market Reforms

- Lower labour costs reduce the costs of production an can lead to increased profits, which in turn may result in greater investment by firms, increased R&D, increased capital goods production, and therefore increases in potential output (economic growth).

1. **Abolishing minimum wage:** elimination or reduction of the legal minimum wage, reduces unemployment by allowing the equilibrium wage to fall.
    - The benefits would include lower unemployment; greater firm profits, as wages costs would be lowered; more investment and economic growth.
2. **Weakening the power of labour (trade) unions:** unionised labour frequently succeeds in securing high wage increases; if labour unions are weakened, wages will be more responsive to the forces of supply and demand, and will therefore be more likely to fall in if there is unemployment.

Supply-side policies: Labour Market Reforms

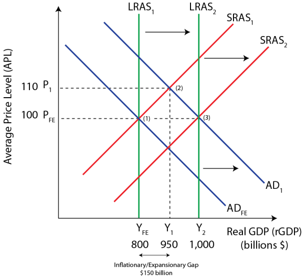
3. **Reducing unemployment benefits**: reducing unemployment benefits, is expected to lower unemployment, as it would encourage the unemployed to look for work.
   - The could work to reduce the natural rate of unemployment.
4. **Reducing job security:** reducing workers' job security may make it easier and less costly for firms to let go of workers.
   - May increase employment, because firms are more likely to hire new workers if they know they can firm them easily and without cost if they are no longer needed.
   - Reducing job security would decrease firms' labour costs because of the lower costs of firing and would therefore increase profits, investment and economic growth.

Supply-side Policies: Incentive-related policies

- **Incentive-related policies** involve cutting various types of taxes, which are expected to change the incentives faced by taxpayers, whether firms or consumers.

1. **Lowering personal income taxes:** reductions in personal income taxes lead to higher after-tax incomes, creating an incentive for people to provide more work.
    - Increase in the number of hours worked per week.
    - Increase in the number of people interested in finding work.
    - Increase in the years worked, as people decide to retire later.
    - Decrease in unemployment as unemployed workers choose to shorten the duration of their unemployment
2. **Lowering taxes on capital gains and interest income:** if taxes on capital gains and on income from interest on savings deposits are reduced, people may be more motivated to save, thus increasing the amount.

3. **Lowering business taxes:** lower taxes on business profits (corporation taxes) can work to increase aggregate demand by increasing investment spending.
   - Cutting taxes on firms' profits can be considered a supply-side measure because increases in the level of after-tax profits mean that firms have greater financial resources for investment and for pursuing technological innovations through more R&D, resulting in greater potential output.



Supply-side policies: Interventionist

- **Interventionist Supply-side policies** any policy based on government intervention in the market intended to affect the supply-side of the economy, usually to shift the LRAS curve to the right, increased potential output and achieve long-term economic growth.
  - Interventionist supply-side policies presuppose that the free market economy along cannot achieve the desired results in terms of increasing potential output, and therefore government intervention is required.

1. **Investment in human capital: education and health services**
   - **Training and education:** more and better training and education lead to an improvement in the quality of labour resources, increasing the productivity of labour, which is one of the key causes of growth.
   - **Improved health care services and access to these:** when workers have access to good quality health care services, they become healthier and more productive.

Supply-side policies: Interventionist

2. **Investment in new technology: research and development:** R&D is the fundamental activity behind the development of new technologies, resulting in new or improved capital goods (physical capital), which is another important cause of increases in potential output and economic growth.
    - R&D also has positive production externalities, thereby justifying government intervention.
    - Governments in many countries around the world are heavily involved in R&D.
3. **Investment in infrastructure:** more and better infrastructure increases efficiencies in production and improves labour productivity thereby lowering costs of production.

Supply-side policies: Interventionist

4. **Industrial policies:** are government policies designed to support the growth of the industrial sector of an economy.

    - **Support for small and medium-sized enterprises or firms (SMEs):** these measures provide support for the private sector, promoting efficiency, more capital formation, more employment possibilities and therefore increases in aggregate demand as well as potential output.
    - **Support for "infant industries":** which are newly emerging industries in developing countries, which sometimes receive government support in the form of grants, subsidies, tax exemptions, and tariffs or other forms of protection against exports.

Overlaps between demand-side and supply-side policies

- **Demand-side policies** are focused on influencing the short-term fluctuations of aggregate demand while **supply-side policies** are intended to affect long run aggregate supply.
  - Some demand-side policies have not only demand-side but also supply-side effects, and can affect long-term economic growth by increasing potential output.
  - Their contribution to economic growth include creating a stable economic environment, as well as private investment spending and government spending.
  - This in turn leads to increases in potential output through new capital formation, increased R&D and technological improvements, and improvements in the quality of the labour force.

Evaluating supply-side policies: Constraints

1. **Time lags:** the policies work after significant time lags, making their effects on the supply-side of the economy (aggregate supply) over the longer term.
   - The activities set into motion (increased competition, labour market reforms, changing incentives) need time to materialize and affect potential output.
   - Policies work after significant time lags because of time needed for investments, new human and physical capital to be realized and to take effect.
2. **Possible unfavourable impact on unemployment:** market-based policies that focus on encouraging competition may well increase unemployment, at least over the short-run.
3. **Possible negative effects on equity:** changes to legislation and institutions that provide protection for workers with very low incomes may contribute to rising income inequalities.

Evaluating supply-side policies: Constraints

4. **Negative impact on the government budget:** incentive-related policies in the form of tax cuts negatively impact the budget as they reduce tax revenues.
    - Interventionist policies have negative effects on the government budget because they are heavily based on government spending. They can therefore create a budget deficit.
5. **Possible inference of vested interests:** market-based policies often affect particular stakeholders in ways which are not in their best interests, and these groups therefore oppose and may prevent the policies from being implemented.
6. **Possible negative effects on the environment:** market-based policies focused on increasing competition may have negative effects on the environment because of the increased scope for activities leading to negative externalities affecting the environment.

Evaluating supply-side policies: Strengths

1. **Improved resource allocation:** market-based supply-side policies focus on improving the workings of the market system based on the operation of demand and supply, and these are expected to result in improved efficiency in resource allocation.

2. **May not burden the government budget:** most market-based policies do not need government funds to be implemented as they are based on private initiatives (tax cuts are an exception).

3. **Ability to create employment:** market-based policies involving labour market reforms may also contribute to reducing the natural rate of unemployment by focusing on making the labour market more responsive to supply and demand.

4. **Ability to reduce inflationary pressure:** by increasing potential output supply-side policies are likely to reduce inflationary pressures over the longer term.

Evaluating supply-side policies: Strengths

5. **Direct support of sectors important for growth:** the government selects particular sectors or activities to promote, which may be important for growth.

6. **Ability to create employment:** interventionist policies involving investments in education and training can make a direct impact on a reduction of unemployment.

7. **Potential ability to reduce inflationary pressure:** interventionist policies may also reduce inflationary pressures by increasing potential output.

8. **Potential positive effects on equity:** interventionist policies that focus on investments in human capital that are broadly distributed throughout the population are likely to have positive effects on equity over the longer-term.

Summary

- **Enduring Understanding**
  - Authorities and organizations institute policies that affect economic growth.
- **Essential Knowledge**
  - Public policies that impact productivity and labour force participation affect real GDP per capita and economic growth.
  - Government policies that invest in infrastructure and technology affect growth.
  - Supply-side fiscal policies affect aggregate demand, aggregate supply, and potential output in the short run and long run by influencing incentives that affect household and business economic behaviour.