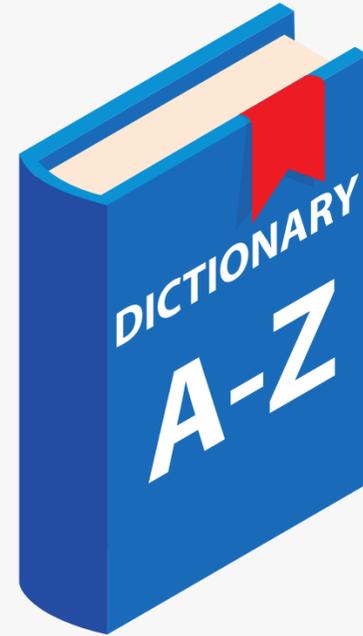


Supply-side Policies

3.7



Definition



Supply-side Policies

Policies aimed at stimulating the supply of an economy by attempting to increase the quantity or quality of the Factors of Production, increase competition, and improve general efficiency of the economy.

Textbook Definition

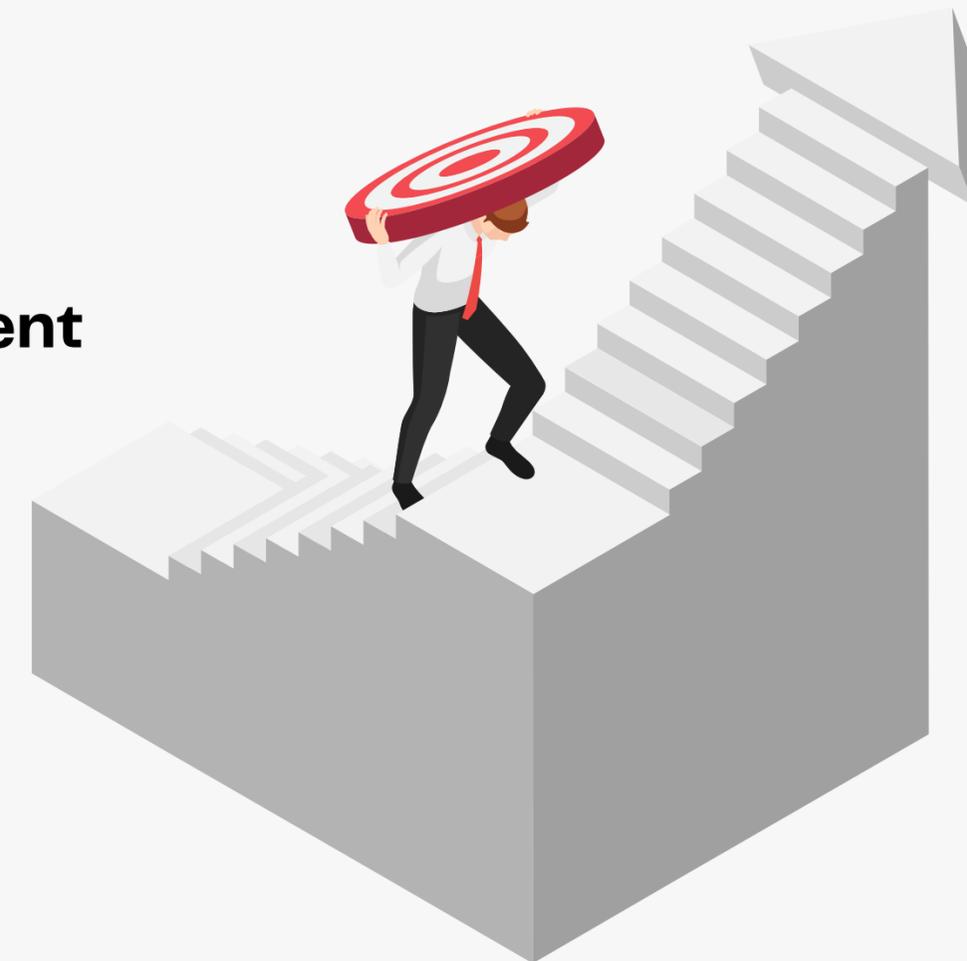
Government policies designed to shift the long-run aggregate supply curve to the right, increasing potential output in the economy and achieving economic growth.

The Goals of Supply-Side Policies



The Goals of Supply-side policies

- **Long-term economic growth by increasing quality/quantity of Factors of Production**
- **Improving competition**
- **Increasing efficiency**
- **Decreasing unemployment and cost of labor**
- **Low and Stable Inflation**
- **Increasing innovation by encouraging Research and Development**



Two Types of Supply-Side Policies

Market-Based (Neo-Classical)

Designed to increase LRAS indirectly by allowing the free-market to regulate itself.

(Invisible Hand)



Interventionist (Keynesian)

Direct intervention by the government to improve the quality/quantity of Factors of Production.



Market Based Policies

- 1. Competition policies**
- 2. Labour market policies**
- 3. Incentive-related policies**



Policies to Increase Competition

One of the central ideas behind supply-side policies is supporting operations of the free market and increasing competition.

Policies aimed at increasing competition

- **Deregulation**
 - Removing rules and restrictions so firms may behave freely
- **Privatization**
 - This occurs when the government transfers ownership of a firm or industry to the private sector.
- **Trade Liberalisation**
 - Removing barriers to trade with other nations to allow for free movement of imports/exports
- **Anti-monopoly regulation**
 - Regulations that are designed to prevent one firm from dominating the market and reducing competition.

Case Study

Click Me



What are the disadvantages and advantages of privatization?

Do you agree with the decisions regarding Air India?

Labour Market Policies

The government has a role in creating a more educated, efficient, and skilled workforce. The labour market should be competitive and flexible.

Policies aimed at creating flexibility and competitiveness in the labour market

- **Reducing or removing unemployment benefits**
 - This type of **transfer payment** could be reduced if they are high enough to discourage or disincentivize qualified or skilled individuals to pursue employment.
- **Removing minimum wages**
 - Minimum wage is a type of **wage floor** and therefore creates inefficiency in the labour market. Removing or reducing minimum wages allows for the free market to work properly.
- **Discouraging or minimizing the power of labour unions**
 - Labour unions always push for higher wages and may interfere with efficiency if workers choose to go on strike.



Incentive-related policies

Implemented to encourage the aggregate supply to increase with a focus on capital and labour.



Increase in Labour – incentives given to individuals

Example

Personal income tax cuts

- Incentivizing workers to work more hours as with tax decreases, they receive more disposable income.
- Incentivizing unemployed people to find jobs faster



If this policy is in effect permanently, long-run aggregate supply (LRAS) will increase resulting in economic growth.

Challenges

Government receives minimal revenue when the tax rate is too low and workers are disincentivized to work if tax rates are too high.

If the government revenue is too low it cannot fund government spending sustainably.

Incentive-related policies

Implemented to encourage the aggregate supply to increase with a focus on capital and labour.

Increase in Capital – incentives given to firms

Example

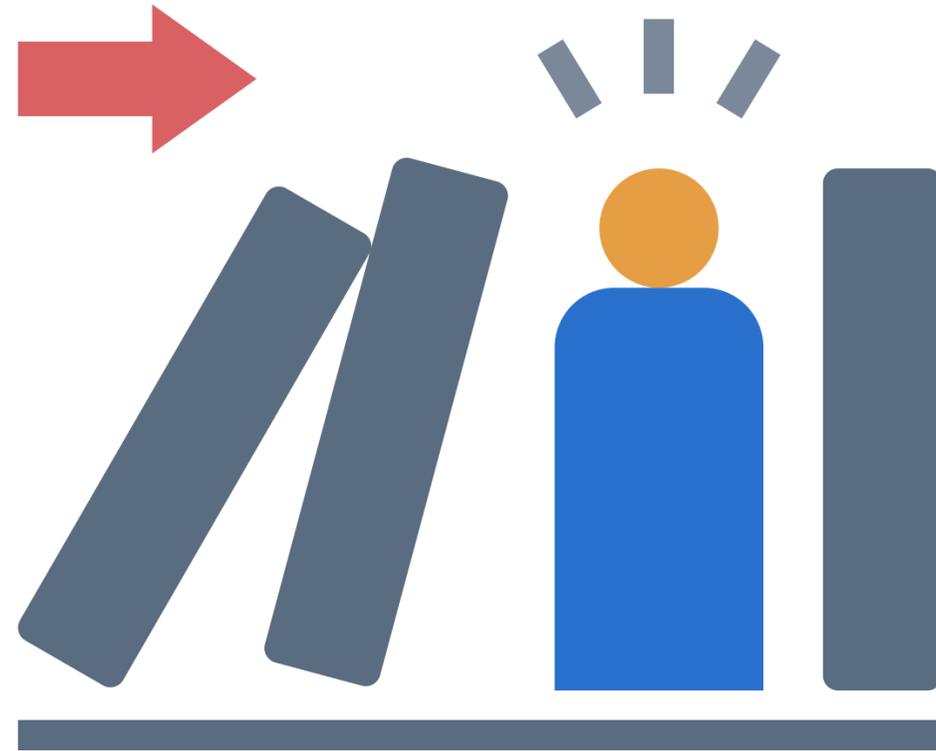
Cuts to business and capital gains tax (the profit a firm makes from selling an asset)



- A decrease in business/corporate tax – Firms generate more profit
- A decrease in capital gains tax – Incentivizes investments and improvement

Additional profit for firms leads to an increase in investment in production resulting in an increase of supply in the economy. A fall in capital gains tax incentivizes firms to improve and update their assets including properties, factories, etc.

Interventionist Supply-Side Policies



Interventionist Supply-Side Policies

The previously discussed market-based supply-side policies aim to remove obstacles to free-market forces.

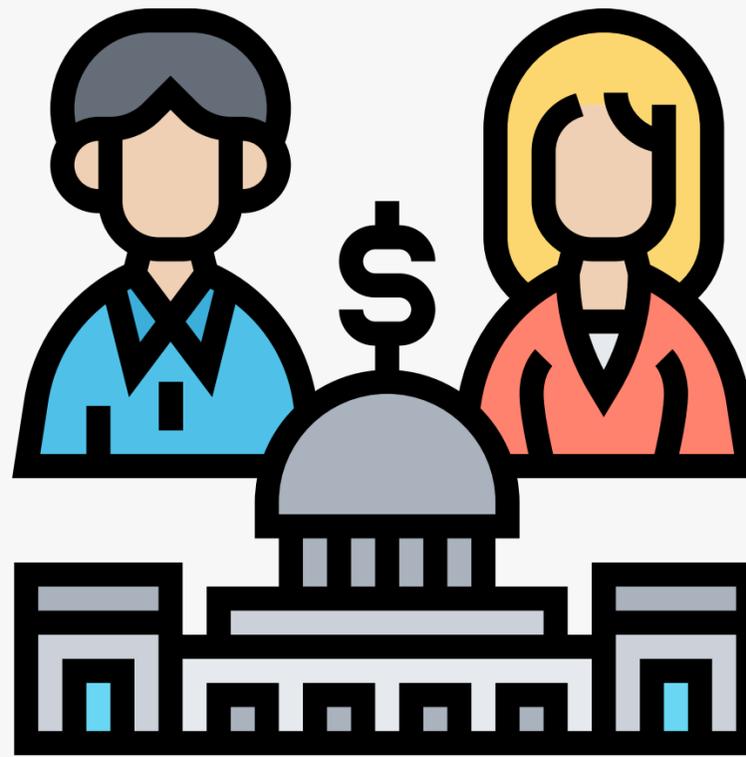
Interventionist Policies involve the government directly intervening in the economy to increase the quality or quantity of the factors of production.



Interventionist Supply-Side Policies

Interventionist Policies:

- Education
- Improving health care
- Improving infrastructure (capital resources that facilitate economic activity typically provided by the government).
- Research and Development
- Industrial Policies



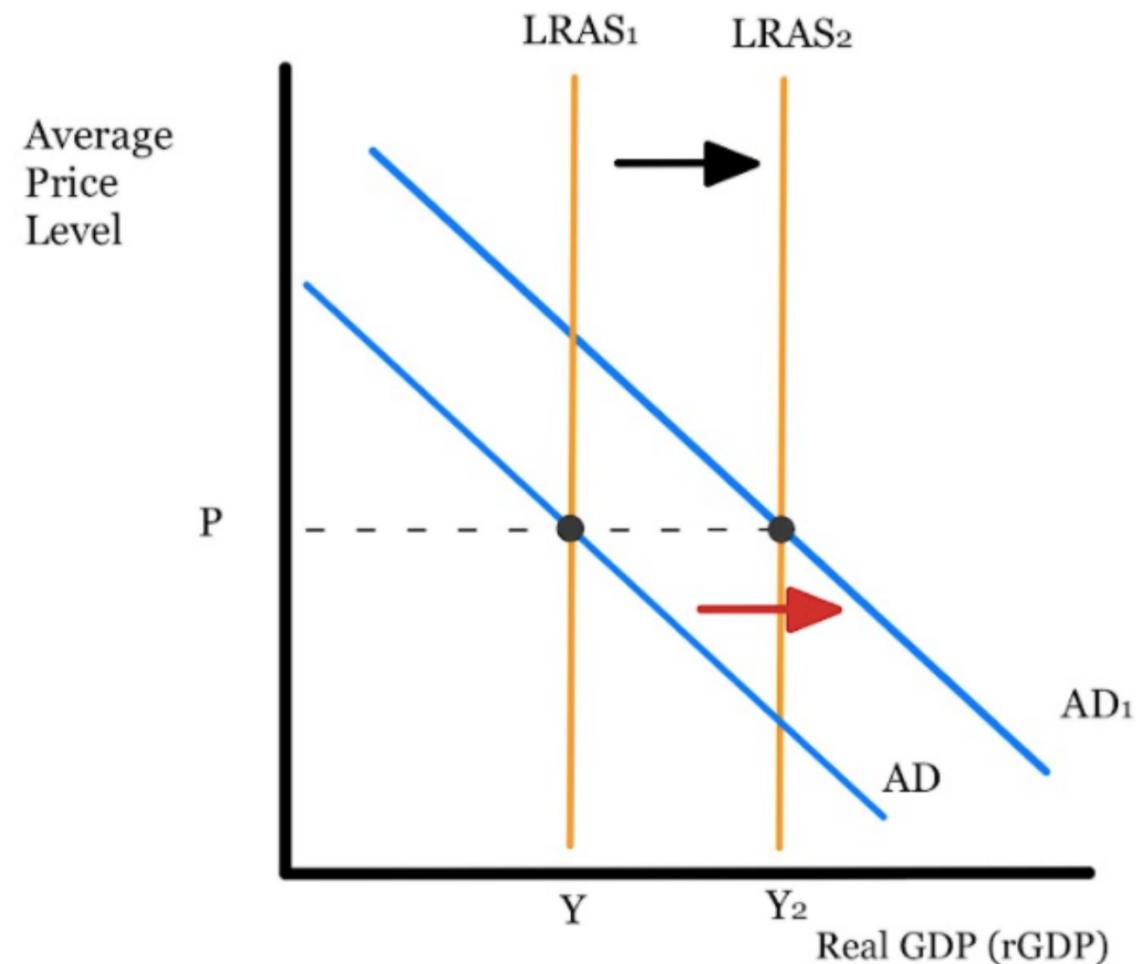
Interventionist Supply-Side Policies

Education and training

Government spending on education is designed to improve **human capital** which improves the quality of workers. Higher quality labour increases productivity and economic growth as the LRAS curve shifts to the right.

Healthcare

Access to high quality healthcare ensures that workers are healthy and able to be productive leading to increased efficiency.



Interventionist Supply-Side Policies

Research and Development

Direct investment for innovation and new technology. These new innovations have the ability to increase efficiency.



Infrastructure Development

Improvements in infrastructure include the development of roads, railroads, airports, public transportation, telephone networks, electrical supply, etc.

Improvements in infrastructure allow for increased general productivity and efficiency.



Industrial Policies

The targeting of development in specific industries or sectors in the economy.

Most commonly, **Import Substitution** is used to subsidize industries to substitute productive from abroad to domestic.

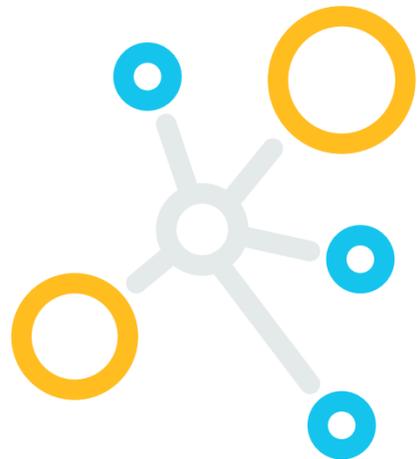
Demand-side effects of Supply-side policies



Connections!

How do you think these supply-side policies affect demand in the economy?

Go through each supply-side policy and determine how it will affect demand.



Demand-side effects of Supply-side policies

Economists argue that supply-side policies alone cannot lead to economic growth. In order for true efficiency or capacity to occur, there must be a corresponding increase in AD.

Luckily, supply-side policies typically have effects on AD.

SS Policies that have demand-side effects:

- Industrial policies
- Cutting personal income taxes
- Reducing unemployment benefits
- Abolishing the minimum wage



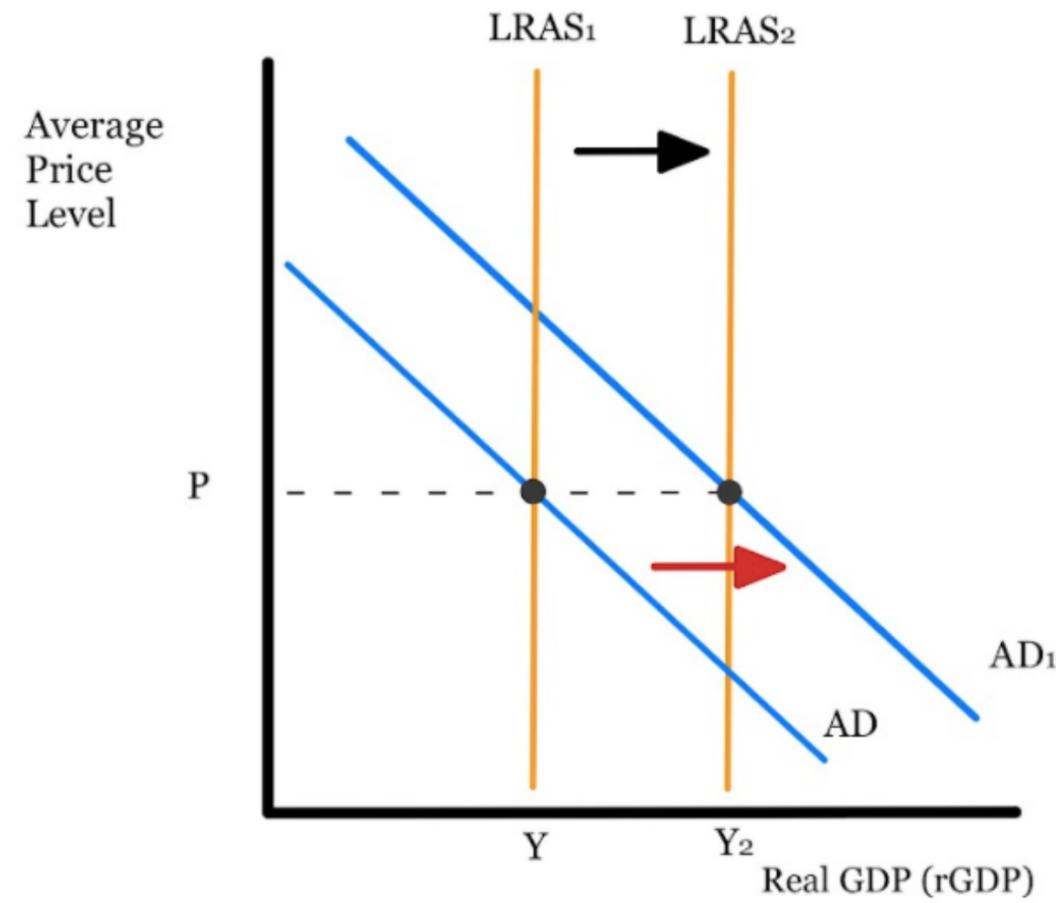
Interventionist Supply-Side Policies

Industrial Policies

When the government chooses to support certain industries, those industries, and their linked industries must hire more workers leading to an increase in income and therefore, consumption.

Reducing Personal Income Tax

Cutting taxes increases disposable income for workers leading to higher consumption.



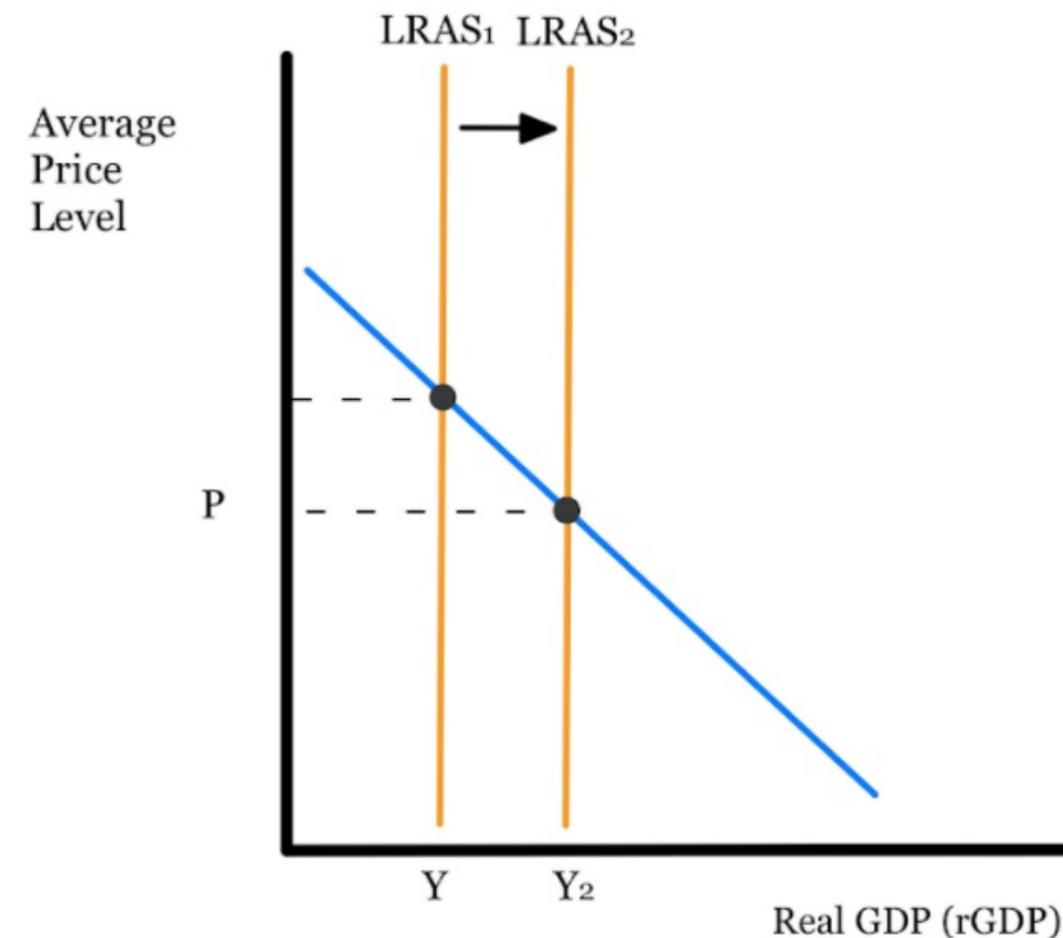
Interventionist Supply-Side Policies

Reducing Unemployment Benefits

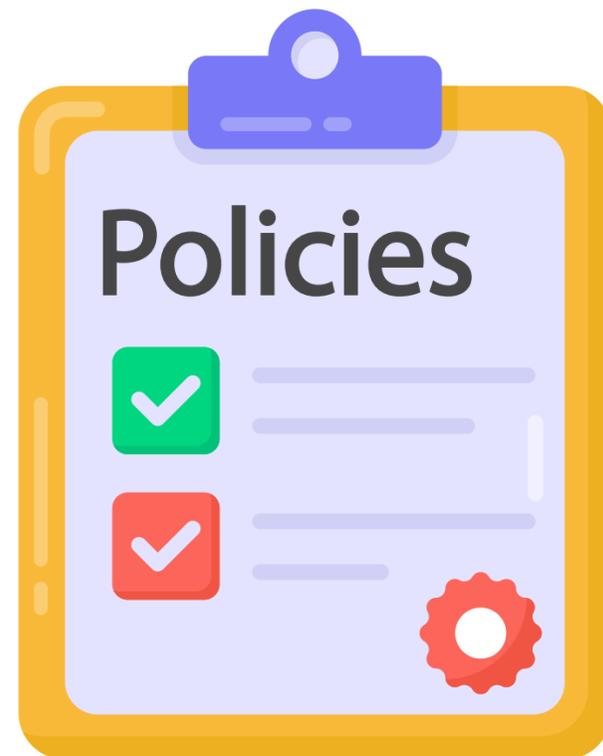
Individuals that were relying on unemployment benefits now much cut back on excess or additional spending. This leads to a decrease in consumption.

Minimum Wage Reduction

Reducing the minimum wage results in workers receiving lower incomes leading to a decrease in consumption.



Fiscal Policy effects on Supply-side



Fiscal Policy Effects on Supply-Side

The use of taxes and government spending are designed to affect AD but the use of fiscal policy can have unintended consequences on the supply side.

How Fiscal Policies affect Supply-side

- **Increase in supply**

- Typically, government spending on things like infrastructure leads to an increase in AD and an increase in the potential of an economy.

- **Crowding out**

- Fiscal policies can crowd out private sectors and reduce their efficiency and productivity. This has a larger effect when the private sector has the desire to participate in a government-dominated market such as infrastructure because private sectors tend to be more innovative and competition-driven.



Effectiveness of Supply-side policies



Constraints on Supply-Side Policies

Market-based Policy Constrains

Equity

- Policies like the reduction of unemployment benefits, minimum wage reductions, and reducing the power of labor unions all can have a detrimental effect on income equality.

Time Lags

- Supply-side policies, like Fiscal Policy, require legislation passed by parliament or congress.

Vested Interests

- Lobbyists have the ability to influence political decisions due to their **vested interest (a government decision directly benefits a firm or industry)**

Sustainability (Environmental Impact)

- Freeing firms from regulations sometimes results in environmental damage.



Constraints on Supply-Side Policies

Interventionist Policy Constraints

Costs

- Supply-side policies can be quite expensive for governments resulting in an increase in the budget deficit and debt.

Time lags

- Once again, government policies are constrained by the legislative process.



Strengths of Supply-Side Policies

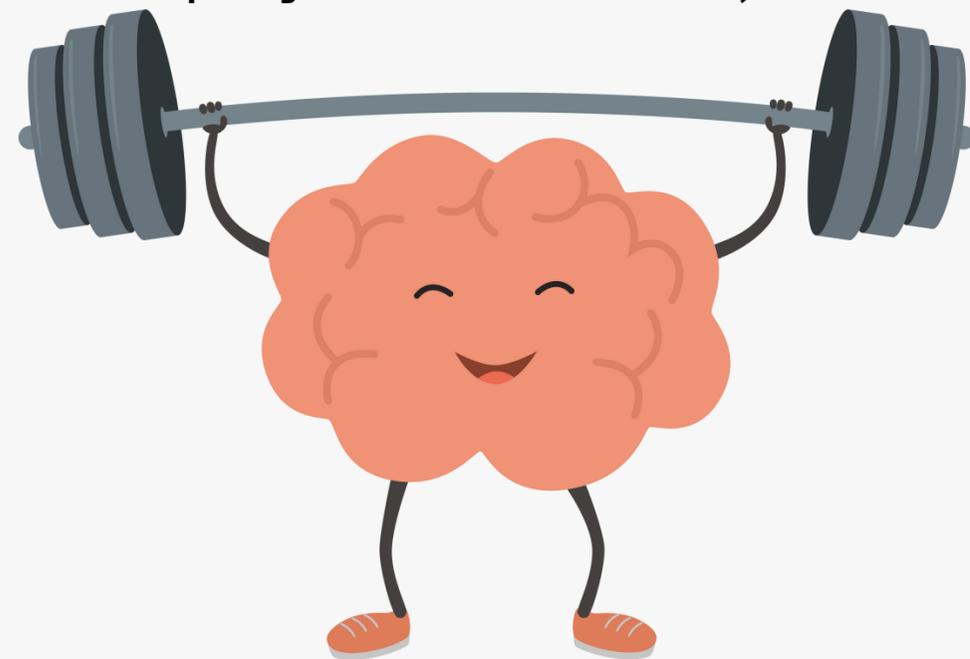
Market-Based Policy Strengths

Improved resource allocation

Government intervention typically results in allocative inefficiency. Removing regulation and supply-side policies

No burden on the government budget

Market-based policies typically do not negatively impact the government budget although at times, it can actual improve the budget (e.g. reduction of unemployment benefits)

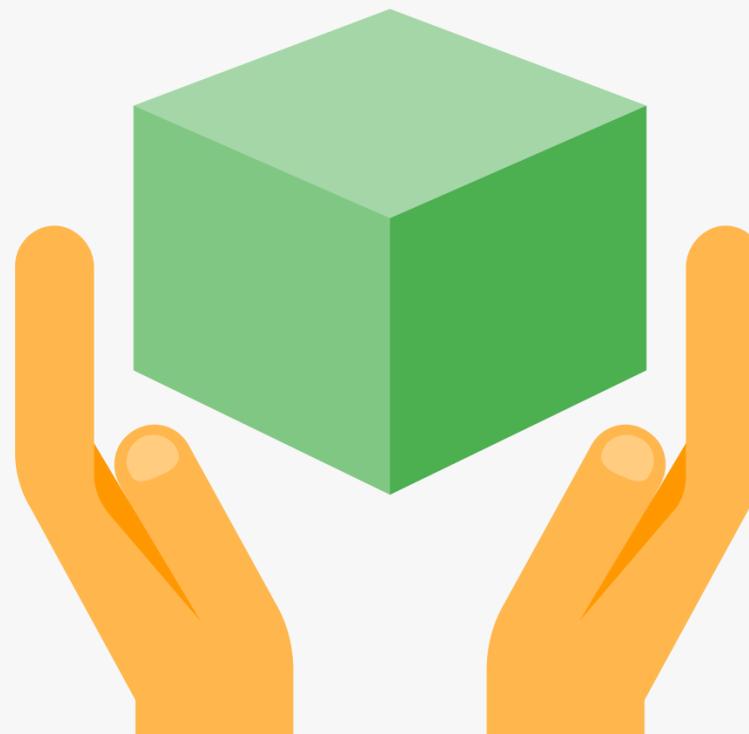


Strengths of Supply-Side Policies

Interventionist Policy Strengths

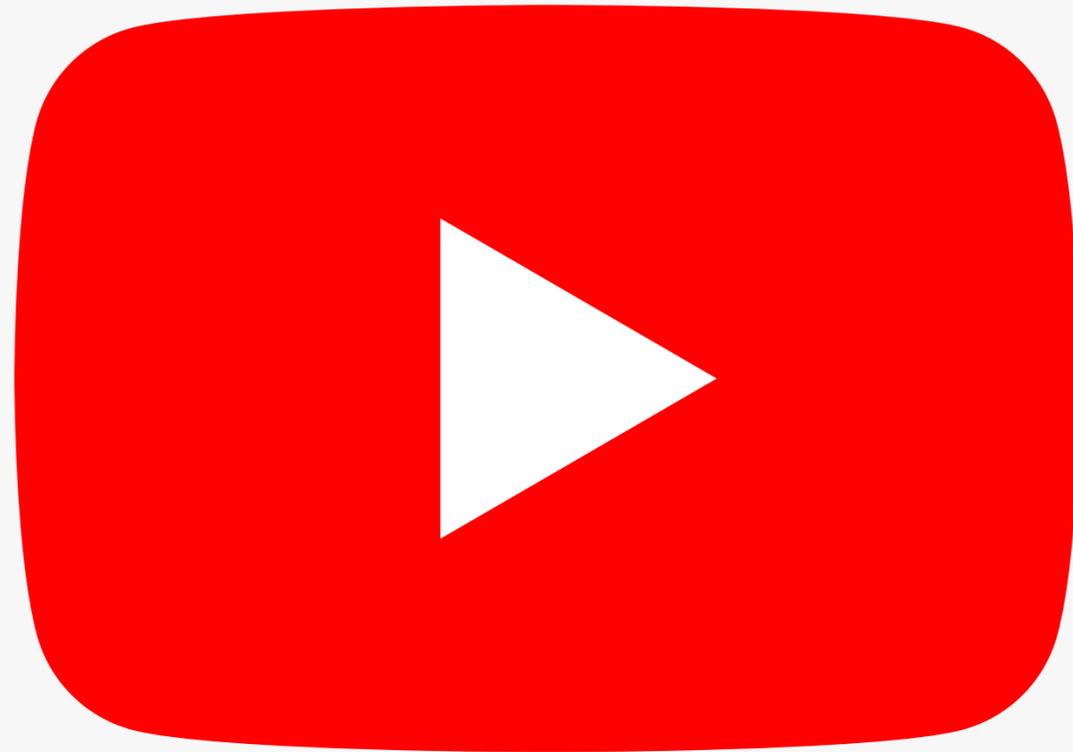
Direct support of sectors important for growth

Interventionist policies can target specific sectors for economic growth by providing resources and funds to aid their growth.



Review Video

Tutor2U – Supply Side Economics



Practice Question



Paper 1

M18/3/ECONO/HP1/ENG/TZ1/XX

(b) Evaluate the view that fiscal policy is the most effective way of achieving long-term economic growth. [15]



Mark Scheme

(b) Evaluate the view that fiscal policy is the most effective way of achieving long-term economic growth.

[15]

Answers may include:

- definition of long-term economic growth , **fiscal policy**
- diagram to show a shift in the PPC and potential output

- Explanation of how fiscal policy leads to long-term economic growth indirectly by creating an economic environment that is favourable to private investment, and directly through government spending on physical capital goods and human capital formation, as well as provision of incentives for firms to invest, all of which are expected to have the effect of increasing potential output

- examples of fiscal policy that has had this effect

- synthesis or evaluation.

N. B It should be noted that definitions, theory and examples that have already been given in part (a) and then referred to in part (b) should be rewarded.

Evaluation may include: the type of fiscal policy and how it is financed, advantages and disadvantages of fiscal policy, consideration of alternative policies, such as monetary and supply-side policies.

Examiners should be aware that candidates may take a different approach which, if appropriate, should be rewarded.

Opinions or conclusions should be presented clearly and should be supported by appropriate examples.

Mark Scheme

Part (a) 10-mark question

Marks	Level descriptor
0–10	
0	The work does not reach a standard described by the descriptors below.
1–2	<ul style="list-style-type: none"> The response indicates little understanding of the specific demands of the question. Economic theory is stated but it is not relevant. Economic terms are stated but they are not relevant.
3–4	<ul style="list-style-type: none"> The response indicates some understanding of the specific demands of the question. Relevant economic theory is described. Some relevant economic terms are included.
5–6	<ul style="list-style-type: none"> The response indicates understanding of the specific demands of the question, but these demands are only partially addressed. Relevant economic theory is partly explained. Some relevant economic terms are used appropriately. Where appropriate, relevant diagram(s) are included.
7–8	<ul style="list-style-type: none"> The specific demands of the question are understood and addressed. Relevant economic theory is explained. Relevant economic terms are used mostly appropriately. Where appropriate, relevant diagram(s) are included and explained.
9–10	<ul style="list-style-type: none"> The specific demands of the question are understood and addressed Relevant economic theory is fully explained. Relevant economic terms are used appropriately throughout the response. Where appropriate, relevant diagram(s) are included and fully explained

Part (b) 15 marks

Marks	Level descriptor
0	<ul style="list-style-type: none"> The work does not reach a standard described by the descriptors below.
1–3	<ul style="list-style-type: none"> The response indicates little understanding of the specific demands of the question. Economic theory is stated but it is not relevant. Economic terms are stated but they are not relevant. The response contains no evidence of synthesis or evaluation. A real-world example(s) is identified but it is irrelevant.
4–6	<ul style="list-style-type: none"> The response indicates some understanding of the specific demands of the question. Relevant economic theory is described. Some relevant economic terms are included. The response contains evidence of superficial synthesis or evaluation. A relevant real-world example(s) is identified.
7–9	<ul style="list-style-type: none"> The response indicates understanding of the specific demands of the question, but these demands are only partially addressed. Relevant economic theory is partly explained. Some relevant economic terms are used appropriately. Where appropriate, relevant diagram(s) are included. The response contains evidence of appropriate synthesis or evaluation but lacks balance. A relevant real-world example(s) is identified and partly developed in the context of the question.
10–12	<ul style="list-style-type: none"> The specific demands of the question are understood and addressed. Relevant economic theory is explained. Relevant economic terms are used mostly appropriately. Where appropriate, relevant diagram(s) are included and explained. The response contains evidence of appropriate synthesis or evaluation that is mostly balanced. A relevant real-world example(s) is identified and developed in the context of the question.
13–15	<ul style="list-style-type: none"> The specific demands of the question are understood and addressed. Relevant economic theory is fully explained. Relevant economic terms are used appropriately throughout the response. Where appropriate, relevant diagram(s) are included and fully explained. The response contains evidence of effective and balanced synthesis or evaluation. A relevant real-world example(s) is identified and fully developed to support the argument.

Socratic Seminar

Demand-Side



Supply-Side

[Link to Resource](#)

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