

Supply-side Policies

Section 2.6

Learning Objectives

- **The role of supply-side policies**
 - Supply-side policies and the economy
 - Explain that supply-side policies aim at positively affecting the production side of an economy by improving the institutional framework and the capacity to produce (that is, by changing the quantity and/or quality of factors of production).
 - State that supply-side policies may be market-based or interventionist, and that in either case they aim to shift the LRAS curve to the right, achieving growth in potential output.

Learning Objectives

- **Interventionist supply-side policies**
 - Investment in human capital
 - Explain how investment in education and training will raise the levels of human capital and have a short-term impact on aggregate demand, but more importantly will increase LRAS.
 - Investment in new technology
 - Explain how increased and improved infrastructure will have a short-term impact on aggregate demand, but more importantly will increase LRAS.
 - Industrial policies
 - Explain that targeting specific industries through policies including tax cuts, tax allowances and subsidized lending promotes growth in key areas of the economy and will have a short-term impact on aggregate demand but, more importantly, will increase LRAS.

Learning Objectives

- **Market-based supply-side policies**
 - Policies to encourage competition
 - Explain how factors including deregulation, privatization, trade liberalization and anti-monopoly regulation are used to encourage competition.
 - Labour market reforms
 - Explain how factors including reducing the power of labour unions, reducing unemployment benefits and abolishing minimum wages are used to make the labour market more flexible (more responsive to supply and demand).
- incentive-related policies
 - Explain how factors including personal income tax cuts are used to increase the incentive to work, and how cuts in business tax and capital gains tax are used to increase the incentive to invest.

Learning Objectives

- **Evaluation of supply-side policies**
 - The strengths and weaknesses of supply-side policies
 - Evaluate the effectiveness of supply-side policies through consideration of factors including time lags, the ability to create employment, the ability to reduce inflationary pressure, the impact on economic growth, the impact on the government budget, the effect on equity, and the effect on the environment.

Links to ToK

- Investment in education and training is a common supply-side policy. What other reasons could there be for supporting the education of the population? What knowledge issues arise in answering the question as to whether government should shoulder this responsibility or whether it should be left to the market?

Introduction to Supply-side Policies

- So far we have focused primarily on the *demand-side* fiscal and monetary policies available to government and the central bank to manage the level of economic activity in a nation.
- Demand-side policies have one major weakness:
 - they are not effective at promoting *long-run economic growth*

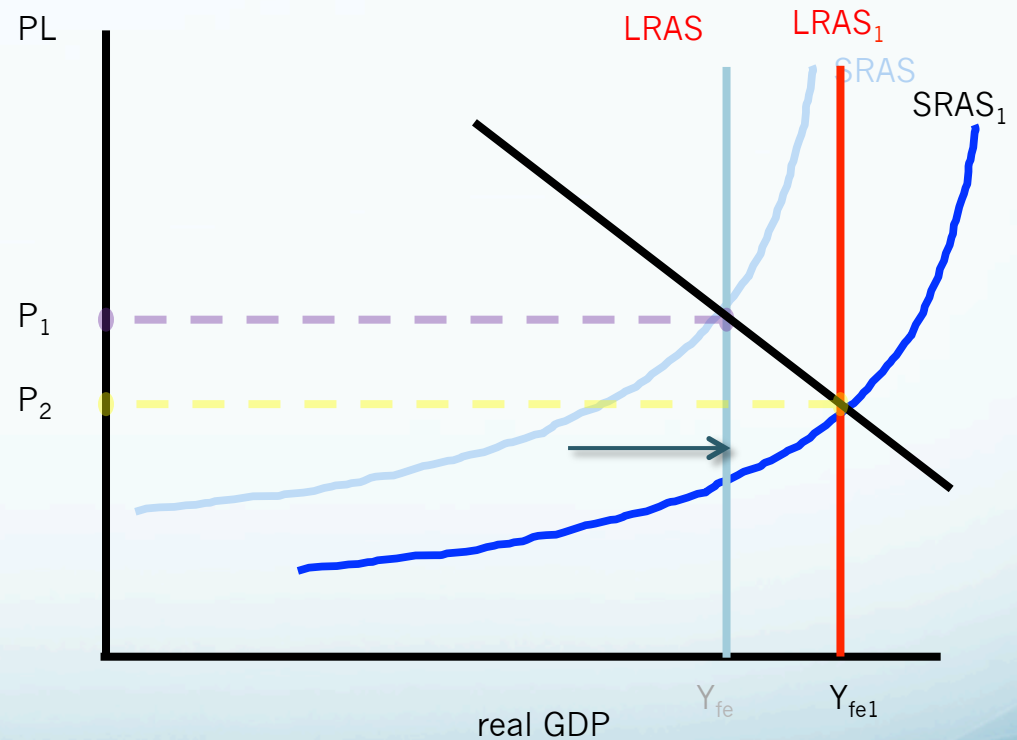
Supply-side policies:

- Measures undertaken by the government aimed at increasing the level of *aggregate supply* in a nation,
- and thereby meant to promote long-run economic growth.
- Examples include:
 - Lower business and income taxes
 - Elimination of a minimum wage
 - Reducing labor union power
 - Reducing unemployment benefits
 - Deregulation
 - Trade liberalization
 - Investments in human capital
 - Investments in physical capital

The Graph

-Supply-side policies increase productivity and reduce production costs, shifting AS outwards.

-Output increases and the average price level decreases



- Explain that supply-side policies aim at positively affecting the production side of an economy by improving the institutional framework and the capacity to produce (that is, by changing the quantity and/or quality of factors of production).

Tax Reform

- Reducing business and personal income taxes can positively impact aggregate supply in two ways:
 - **Business taxes are a cost of production**
 - **Income taxes serve as a disincentive to work**

Business taxes are a cost of production:

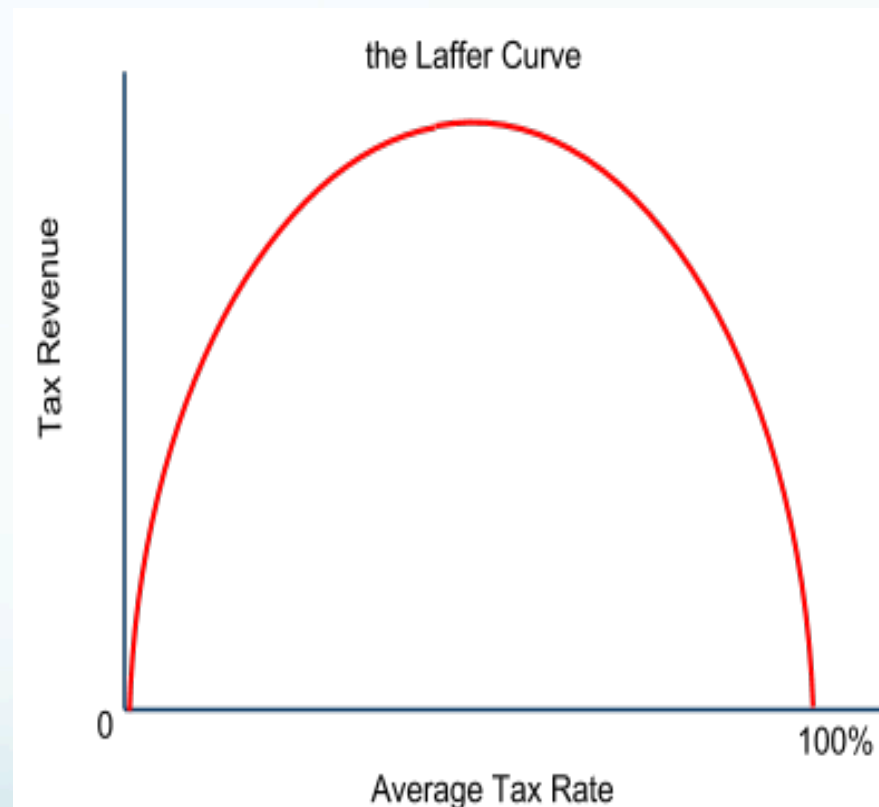
- Lowering taxes on firms reduces the cost of doing business.
- Allowing business owners to keep a larger share of their earned revenues should incentivize new investments in capital and technology,
- which increase the productivity of labor and reduce costs, shifting AS outwards.

Income taxes serve as a disincentive to work:

- One argument against high marginal income taxes on households goes
- that *if you tax higher income at higher rates, households have a disincentive to work hard and earn higher incomes.*

Tax-The Laffer Curve

- This theory argues that at a certain point, an increase in tax rates will lead to a decrease in tax revenues, if the tax rate is so high that less output is produced.
- In contrast, if tax rates are lowered below this level, then tax revenues may actually increase.
- **The Laffer Curve:** Shows the theoretical relationship between the tax rate and tax revenues. Commonly used to support the supply-side argument for lowering taxes



Test Your Knowledge

- With your partner, answer the following question
- Post on your blogger site
- Explain how factors including personal income tax cuts are used to increase the incentive to work, and how cuts in business tax and capital gains tax are used to increase the incentive to invest.

Labor Market Reforms

- Labor is the most important (and the most costly) resource for most nations' producers.
- Reforms of the labor market that bring down the cost of labor will increase a nation's AS and lead to growth in national output.
- Supply-side Labor Market Reforms include:
 - **Reducing or eliminating the minimum wage**
 - **Reducing labor union power**
 - **Reducing government spending on unemployment benefits**

Reducing or eliminating the minimum wage:

- The minimum wage is a *price floor in the labor market* set above the free market equilibrium wage rate.
- Minimum wage laws increase the cost of hiring workers in certain industries (typically the low-skilled sectors).
- Reducing or eliminating minimum wages may lead firms to hire more workers and thereby produce more output at a lower per unit cost

Reducing labor union power:

- Labor unions are organizations of workers in particular industries that negotiate with employers for better worker benefits, such as higher wages, more paid vacation, better health care and so on.
- Such benefits add to firms' production costs and keep aggregate supply lower than it might be otherwise.
- Reducing the power of unions will lower labor costs for producers and shift AS outwards.

Reducing government spending on unemployment benefits:

- Unemployment benefits are the money payments individuals received during the period of time when they are out of work and seeking a new job.
- Reducing these benefits would create an incentive for unemployed workers to accept a new job more quickly and at a lower wage rate than they otherwise might accept.
- Firms will find more workers willing to work for lower wages.

Test Your Knowledge

- With your partner, answer the following question
- Post on your blogger site
- Explain how factors including reducing the power of labour unions, reducing unemployment benefits and abolishing minimum wages are used to make the labour market more flexible (more responsive to supply and demand).

Deregulation

- One of the roles of any government is to regulate the activities of producers in the free market.
- The goals of regulation are often to reduce the impact of negative externalities arising from the production or consumption of certain goods.
 - The cost of complying to government regulation increases firm's average costs and reduces the level of AS
 - Removing or loosening regulations in certain industries will lead to lower costs and greater output, increasing AS.

Example:

- The United States Environmental Protection Agency is often accused of imposing harmful regulations on producers of good ranging from automobiles to electricity to agricultural products.
- **The benefit of environmental regulations**
 - is the reduced emissions of harmful toxins that affect human health and the environment.
- **The cost of environmental regulations**
 - is the impact they have on employment and the price level.
 - Reducing them will lead to *more output and lower prices* in the regulated industries,
 - *however the tradeoff may be increased environmental degradation and reduced human health*

Trade Liberalization

- Free trade refers to the exchange of goods and services between nations *without protectionism by the government.*

Protectionism:

- The use of tariffs, quotas or other measures aimed at making domestic producers more competitive with foreign producers by limiting the quantity of imports into the nation.
- **Tariffs:** Taxes placed on imported goods, services or resources
- **Quotas:** A physical limit on the quantity of a good, service or resource that may be imported

The supply-side effects of trade liberalization:

- Reducing protectionism will allow some producers in a nation to import raw materials and other imported factors of production more cheaply, lower their average production costs
- More competition from foreign producers will force domestic firms to use their resources in a more efficient manner, since they will either have to reduce their production costs or lose out to foreign competition.
- Both lower production costs and increased competition lead to an increase in the nation's aggregate supply and contribute to long-run economic growth.

Test your knowledge

- With your partner, answer the following question
- Post on your blogger site
- Explain how factors including deregulation, privatization, trade liberalization and anti- monopoly regulation are used to encourage competition.

Investments in Human and Physical Capital

- Not all investment needed for economic growth will be undertaken by the private sector.
- **Merit and Public goods:**
 - Recall from our unit on *market failure* (part of the Micro course), there are certain goods which are *under-provided by the free market*.
 - Such goods provide social benefits which exceed the benefit to the individual consumer
 - They may also be non-excludable, meaning once they are provided, it is difficult for the producer to charge individuals to use them
 - For these reasons, such goods will be under-provided by the free market, and therefore if society wishes to have them, it is up to the government to provide them

Education as a merit good:

- Because the benefits of having an educated population are *social in nature*, it is often up to the government to promote education through public schools.
- A better educated workforce is more productive, and provides firms with higher skilled workers to produce more and better output
- A better educated workforce will earn higher incomes and thus pay more in taxes, allowing government to earn more revenues with which it can provide other merit and public goods

Infrastructure as a public good:

- Due to the fact that it is non-excludable, certain types of infrastructure (roads, sanitation, electricity grids, communication infrastructure) may need to be provided by the government
- Better infrastructure reduces the costs for private businesses and allows them to operate more efficiently
- Because private firms do not have to build their own roads or railways, they are able to produce and sell their products at lower costs. A modern, efficient infrastructure allows for AS to increase over time.

Test Your Knowledge

- With your partner, answer the following question
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 - Explain how investment in education and training will raise the levels of human capital and have a short-term impact on aggregate demand, but more importantly will increase LRAS.
 - Explain how increased and improved infrastructure will have a short-term impact on aggregate demand, but more importantly will increase LRAS.

Evaluation of Supply-side Policies

- A policy that increases aggregate supply appears to be overwhelmingly beneficial for a nation's economy.
- The average price level of goods and services decreases, while...
- Output increase, and...
- Employment increases...
- **However, such policies are often difficult to undertake and may have some undesirable consequences:**
 - **Increased inequality**
 - **Environmental concerns**
 - **Political realities**

Increased inequality:

- Supply-side labor market reforms often result in lower incomes for the working class in a nation, as unemployment benefits, labor union power and minimum wages are all reduced.
- Supply-side tax reforms may also redistribute the total burden of taxes in a nation away from the higher income earners and more onto the middle and lower income earners

Environmental concerns:

- Decreased regulation of the private sector may lead firms to find new ways to externalize costs on third parties, often times meaning increased environmental damage

Political realities:

- Increasing spending on education and infrastructure is often times politically difficult due to the fact that the payoff from such investments are often not seen for years or even decades,
- long after the members of the current government are out of office

Test Your knowledge

- With your partner, answer the following question
- Post on your blogger site
- Evaluate the effectiveness of supply-side policies through consideration of factors including time lags, the ability to create employment, the ability to reduce inflationary pressure, the impact on economic growth, the impact on the government budget, the effect on equity, and the effect on the environment.