AQA A Level Economics

Your notes

13. Fiscal & Supply-side Policies

Contents

Fiscal Policy: An Introduction

Your notes

Fiscal Policy

- Fiscal Policy involves the use of **government spending and taxation** (revenue) to influence **aggregate demand** in the economy
- Fiscal policy can be **expansionary** in order to generate further economic growth
  - Expansionary policies include reducing taxes or increasing government spending
- Fiscal policy can be **contractionary** in order to slow down economic growth or reduce inflation
  - Contractionary policies include increasing taxes or decreasing government spending
- Fiscal Policy is usually presented annually by the Government through the **Government Budget**
  - A **balanced budget** means that **government revenue = government expenditure**
  - A **budget deficit** means that **government revenue < government expenditure**
  - A **budget surplus** means that **government revenue > government expenditure**
- A budget deficit has to be financed through **public sector borrowing**
  - This borrowing gets added to the **public debt**

Macroeconomic & Microeconomic Impacts of Fiscal Policy

Macroeconomic impacts

- Fiscal policy is used to help the government achieve their **macroeconomic objectives**
- Specifically, the use of fiscal policy aims to
  - Maintain a low and stable rate of **inflation**
  - Maintain **low unemployment**
  - Reduce the **business cycle fluctuations**
  - Create a stable economic environment for long-term **economic growth**
  - Redistribute income so as to ensure more **equity**
  - Control the level of exports and imports (**net external balance**)

Your notes

- When a policy decision is made, it creates a ripple effect through the economy, impacting the macroeconomic objectives of the government
- Changes to fiscal policy can influence several of the components of **AD**
    - A change to any **component of AD** helps to achieve at least one of the **goals of fiscal policy**

Microeconomic impacts

- Fiscal policy includes making changes to policies such as taxes and subsidies
    - Income tax cuts can influence labour to be more productive
    - Tax cuts can encourage firms to increase output or be more entrepreneurial
    - Subsidies can lower costs of production in the industry, leading to higher output

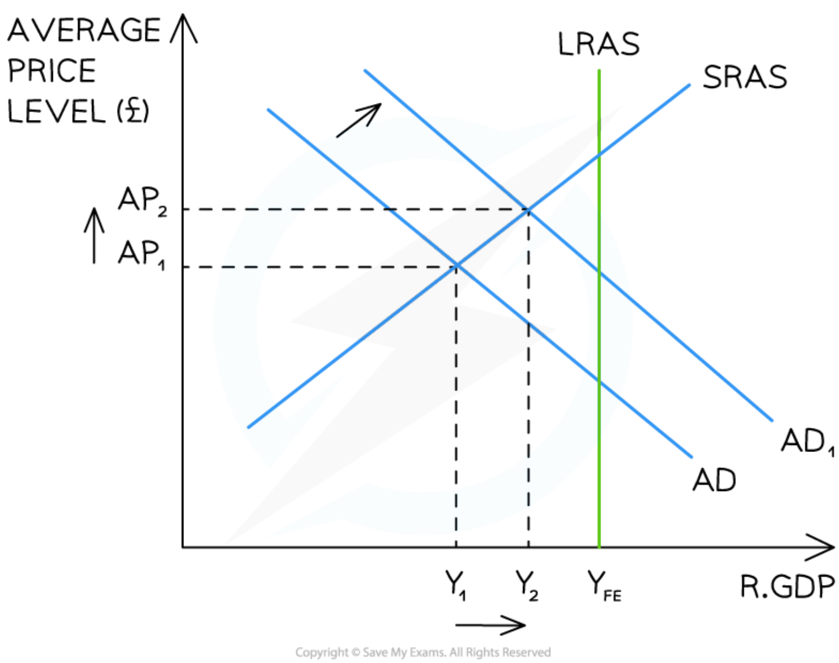
Fiscal Policy and Aggregate Demand

Expansionary fiscal policy

- Expansionary fiscal policies include **reducing taxes** or **increasing government spending** with the aim of increasing AD
- AD = household consumption (C) + firms investment (I) + government spending (G) + exports (X) - imports (M)
    - **AD = C + I + G + (X – M**
- **Expansionary fiscal policy** aims to shift aggregate demand (AD) to the **right**

Diagram: expansionary fiscal policy

Your notes



Expansionary fiscal policy which increases real GDP (Y1 →Y2) and average price levels (AP1 →AP2)

Diagram analysis

- The economy is initially in macroeconomic equilibrium **AP1Y1:** there is a **recessionary gap**
- The Government wants to boost economic growth and lowers the rate of income and corporation taxes
- **Lower taxes** cause **investment and consumption** to increase, which are components of AD
- Aggregate demand increases from **AD→ AD_1**
- The economy reaches a new equilibrium at **AP_2Y_2** - a higher average price level and a greater level of national output

Examples of the Impact of Expansionary Fiscal Policy

Example 1: The Government decreases corporation tax	
Effect on the economy	▪ Firms net profits increase → investment by firms increases → AD increases

Your notes

Impact on macroeconomic aims	▪ Economic growth increases ▪ Inflation rises ▪ Unemployment may decrease as output is rising which requires more workers ▪ Net external demand - unsure - exports may rise due to new investments in the economy, but imports may rise due to higher income generated by the investment

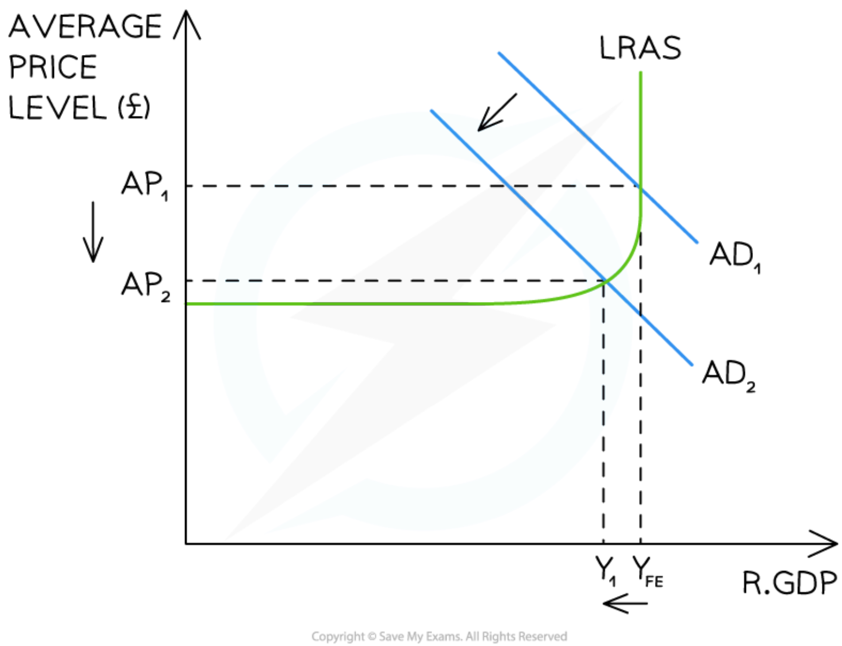
Example 2: The Government increases unemployment benefits	
Effect on the economy	Household income increases → consumption increases → AD increases
Impact on macroeconomic aims	▪ Economic growth increases ▪ Inflation rises ▪ Unemployment may decrease as output is rising which requires more workers (although increased unemployment benefits may discourage some people from entering the labour market) ▪ Net external demand is unlikely to change as this policy helps the poorest and imports are unlikely to increase ▪ Redistribution of income has increased and there is more equity in society

Contractionary fiscal policy

- Contractionary fiscal policies include **increasing taxes** or **decreasing government spending** with the aim of decreasing AD
- AD= household consumption (C) + firms investment (I) + government spending (G) + exports (X) - imports (M)
  - **AD = C + I + G + (X – M**
- Changes to fiscal policy can influence government spending or consumption or investment
  - Changing taxation can influence household consumption and the investment by firms
- Contractionary fiscal policies aims to shift aggregate demand (AD) to the **left**

Diagram: contractionary fiscal policy

Your notes



Contractionary fiscal policy aims to decrease real GDP (YFE →Y1) and average price levels (AP1 →AP2)

Diagram analysis

- The economy is initially in macroeconomic equilibrium $\mathbf{AP_1Y_{FE}}$ - an inflationary output gap is developing
- The economy is booming and the Government wants to lower inflation towards its target of 2%
- The Government increases the **rate of income tax**
- Higher tax rates cause households to have less discretionary income, causing consumption to decrease
- Aggregate demand decreases from **AD1→ AD2**
- The economy reaches a new equilibrium at $\mathbf{AP_2Y_1}$ - a lower average price level and a smaller level of national output

Examples of the Impact of Contractionary Fiscal Policy

Example 1: The Government increases the rate of income tax

Effect on the economy	▪ Households pay **more tax** → discretionary income reduces → consumption reduces → AD reduces
Impact on macroeconomic aims	▪ Economic growth slows down ▪ Inflation eases ▪ Unemployment may increase as output is falling and fewer workers are required ▪ Net external demand Improves (with less income, imports may fall)

Example 2: The Government freezes/reduces public sector workers pay	
Effect on the economy	▪ Wages stagnate or reduce → Consumer confidence falls → consumption decreases → AD decreases
Impact on macroeconomic aims	▪ Economic growth slows down ▪ Inflation eases ▪ Unemployment may increase as output is falling ▪ Net external demand improves (with less income, imports may fall)

Example 3: The Government cuts Government Spending in their Budget	
Effect on the economy	▪ Less demand for goods/services → less income for firms → output and profits decrease → AD decreases
Impact on macroeconomic aims	▪ Economic growth slows down ▪ Inflation eases ▪ Unemployment may increase as output falls ▪ Net external demand may Improve (with less income, imports may fall) ▪ Less corporation tax available for redistribution

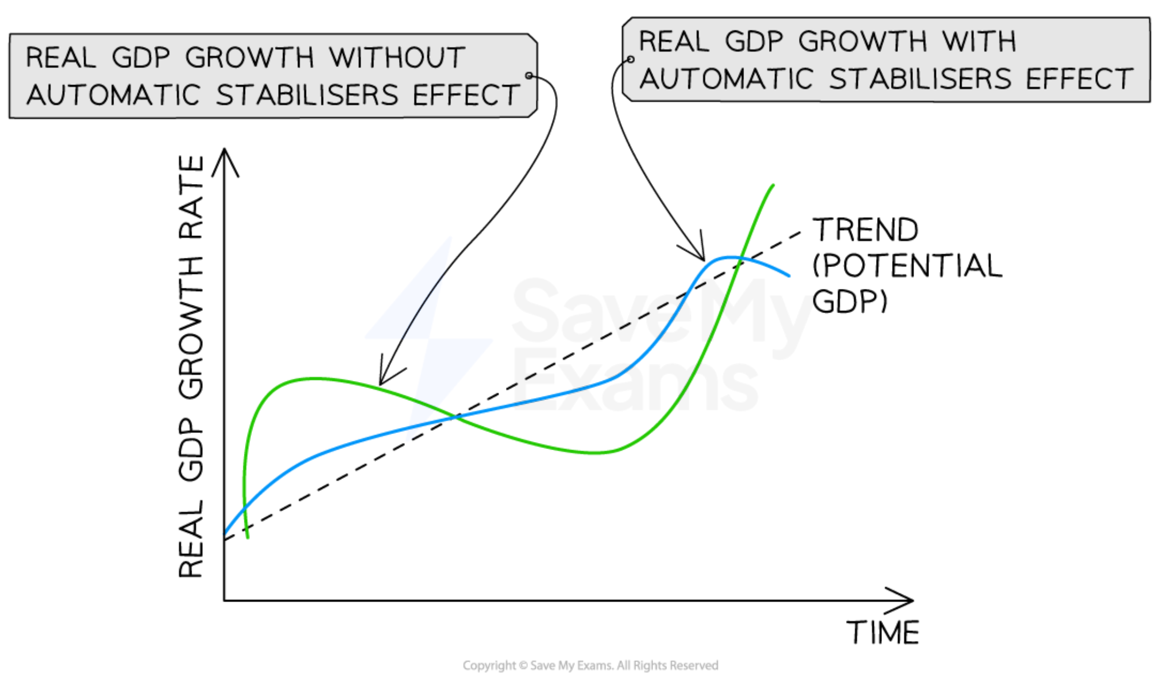
Fiscal Policy & Aggregate Supply

Your notes

- Many **fiscal policies** have the ability to improve the **productive potential (supply-side)** of an economy
  - E.g. Education subsidies to help the poorest households constitute an annual expenditure for the government. However, in the long term, they help to **improve human capital,** which boosts productivity and output
  - The fiscal policy is short-term (annually); however, the supply-side impact occurs in the long term

The Influence of Taxation & Spending on Economic Activity

- Government spending and taxation influence the level of economic activity
  - Government spending is an **injection** and increases economic activity
  - Taxation is a **withdrawal** and decreases economic activity
- The government budget is usually set once a year
- This fiscal policy then operates automatically in the background producing a stabilising effect as the economic activity fluctuates
  - **Automatic stabilisers** are **automatic fiscal changes** that occur as the economy moves through stages of the **business/trade cycle**



The impact of automatic stabilisers on an economy during a boom and recession

Your notes

Effects in a recession

- In a recession, there will automatically be **lower tax revenue due to the nature of progressive taxation** - as incomes fall **households are taxed less**
- In a recession, as unemployment rises, the government will pay **higher unemployment benefits** and transfer payments, which households will then use **for consumption**
- Both of the above will result in **real GDP being higher** than it would otherwise have been

Effects in a boom

- In a boom, there will automatically be **higher tax revenue due to the nature of progressive taxation** - as incomes rise, **households are taxed more**
- In a boom, as unemployment falls, the government will pay **fewer unemployment benefits** / transfer payments which will decrease household consumption
- Both of the above will result in **real GDP being lower** than it would otherwise have been
- This is effectively an **automatic disinflationary effect**

Fiscal Policy: Types of Public Expenditure & Taxation

Your notes

Sources of Government Revenue

- The main sources of government revenue include **taxation,** the sale of goods/services by government owned firms, and the sale of government owned assets (privatisation)

1. Taxation

- **Direct taxes** are taxes imposed on **income and profits**
  - They are **paid directly** to the government by the individual or firm
    - E.g. Income tax, corporation tax, **capital gains tax**, national insurance contributions, inheritance tax
- **Indirect taxes** are imposed on **spending**
  - The **supplier** is responsible for sending the payment to the government
    - Depending on the **PED** and **PES** producers are able to pass on a proportion of the indirect tax to the consumer
    - The **less** a consumer spends the **less indirect tax** they pay
    - E.g Value Added Tax (20% VAT rate in the UK in 2022), taxes on **demerit goods**, excise duties on fuel etc.

2. Sale of goods and services

- Government owned firms sometimes **charge for the goods/services** that they provide
  - E.g. Charges on public transport and fees paid to access some medical services

3. The sale of government owned assets

- **Privatisation** can generate significant **government revenue** during the year in which the government sells the asset
  - Most assets can only be sold once e.g. national airlines or railways
  - Some assets, such as the right for **mobile phone operators** to use the airwaves, can be sold every few years (the airway licence is for a defined period of time)

Types of Government Expenditure

- **Government expenditure** represents a significant portion of the **aggregate demand** in many economies

Your notes

- The expenditure can be broken down into three categories:

1. **Current expenditures:** These include the **daily payments** required to run the government and public sector. E.g. The wages and salaries of public employees such as teachers, police, members of parliament, military personnel, judges, dentists etc. It also includes payments for goods/services such as medicines for government hospitals

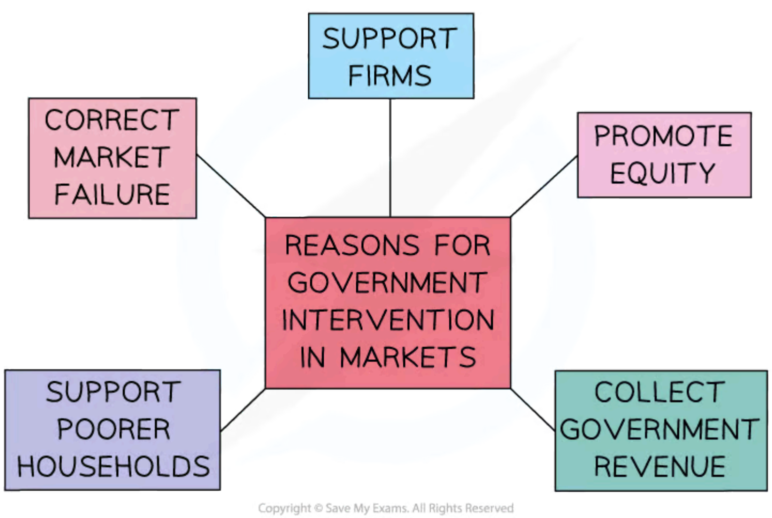
2. **Capital expenditures:** These are investments in **infrastructure** and capital equipment. E.g. High speed rail projects; new hospitals and schools; new aircraft carriers

3. **Transfer payments:** These are payments made by the government for which **no goods/services are exchanged.** E.g. Unemployment benefits, disability payments, subsidies to producers and consumers etc. This type of government spending does not **contribute to aggregate demand,** as income is only transferred from one group of people to another

Why Governments Levy Taxes

- Tax revenue is required to fund **government expenditure**

Diagram: reasons for government tax interventions



Taxes can be used to raise revenue, correct market failure, or generate more equity in society

- Taxes can be used to **discourage consumption**
  - **Excise taxes** (on alcohol, cigarettes) can be used to reduce the consumption of demerit goods that create **negative externalities**
  - Tariffs (taxes on imports) can reduce imported goods

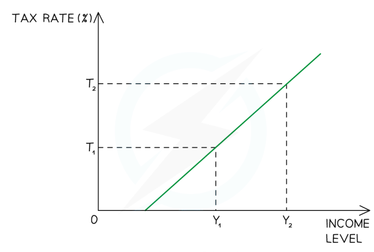
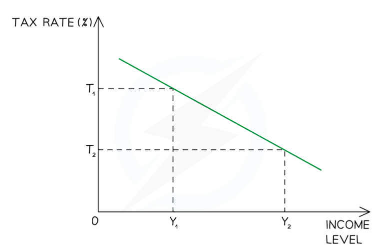
Your notes

- Taxes should aid the **redistribution of income**
  - A good tax system should help the government redistribute income from the rich to the poor
  - Revenue could also be used through the **provision of services**
    - Eg. Health care and education promote more opportunities for lower-income earners

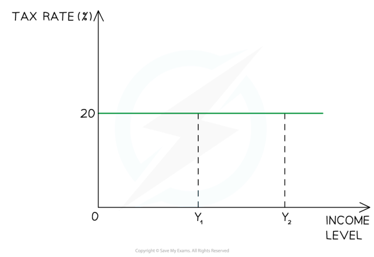
Progressive, Proportional and Regressive Taxes

- Tax systems can be classified as **progressive**, **regressive or proportional**
- Most countries have a **mix** of progressive **(direct taxation)** & regressive **(indirect taxation)** taxes in place

An Explanation of Tax Systems

System	Explanation	Diagram
Progressive	▪ As income rises, **a larger percentage** of income is paid in tax ▪ In the diagram, when personal **income rises** from Y_1 to Y2, the **tax rate rises** from TR_1 to TR_2	
Regressive	▪ As income rises, **a smaller percentage** of income is paid in tax ▪ In the diagram, when personal **income rises** from Y_1 to Y2, the **tax rate falls** from TR_1 to TR_2 ▪ All indirect taxes are regressive ▪ In the USA, **Federal income tax** is progressive but almost all **State taxes** are regressive (the bottom 20% of income earners pay as much as 6x the % of their income than the top 20%)	
Proportional	▪ As income rises, **the same percentage** of income is paid in tax	

Your notes

	▪ In the diagram, when personal **income rises** from Y_1 to Y2, the tax rate remains constant at 20% ▪ In 2022, Bolivia was using this system with a **proportional tax** rate of 13%	

- **Progressive tax systems** are built around the idea of **marginal tax rates**
- The calculation of an individual's personal income tax **requires several calculations**
- Using this system, a **salary** of £60,000 would attract a **tax bill** of £11,499.80, calculated as follows:

Calculation Using UK Progressive Tax Rates - June 2022

Tax Band	Taxable Income	Tax Rate	Tax Paid on £60,000
Personal Allowance	Up to £12,500	0%	0
Basic Rate	£12,501 to £50,000	20%	£37, 499 at 20% = £7499.80
Higher Rate	£50,001 to £150,000	40%	£10,001 at 40% = £4,000
Additional Rate	Over £150,000	45%	0
Total Tax Paid on £60,000			£7499.80 + £4,000 = **£11,499.80**

- The **average tax rate** measures the overall burden of the tax on the taxpayer

$$\text{The Average Tax Rate} = \frac{\text{Total tax paid}}{\text{income}} \times 100 \text{ or } \frac{T}{Y} \times 100$$

- The **marginal tax rate** is the tax paid on the last pound of income earned

$$\text{The Marginal Tax Rate} = \frac{\text{Change in total tax paid}}{\text{Change in income}} \times 100 \text{ or } \frac{\Delta T}{\Delta Y} \times 100$$

Your notes

Worked Example

Calculate the average tax rate for an individual who has an income of £38,000

Taxable income (£)	Income Tax Rate 2014/2015
from £0 to £5 000	0%
from £5 001 to £20 000	20%
from £20 001 to £40 000	40%
£40 001 and over	50%

Step 1: Calculate tax on each bracket

Individual pays tax: (5,000 x 0%) + (15,000 x 20%) + (18,000 x 40%)

Step 2: Sum each bracket

0 + £3,000 + £7,200 = £10,200

Step 3: Substitute values into the formula

$$The\ Average\ Tax\ Rate = \frac{Total\ tax\ paid}{Income} \times 100$$

$$The\ Average\ Tax\ Rate = \frac{£\,10{,}200}{£\,38{,}000}\ x\ 100$$

$$The\ Average\ Tax\ Rate = 26.84\%$$

The Principles of Taxation

- In order for the population to accept a tax system and pay into it, the taxes imposed need to be considered to be **'good'**
- There are several **principles** which should be applied when developing a **'good' tax system**

1. **Simple:** taxpayers should know what, when, where and how to pay the tax
2. **Fair (equity):** taxes should reflect a taxpayer's ability to pay; progressive taxation aims to achieve this as the wealthy can afford to pay more than the poor do

3. **Convenient:** systems to collect payment should be easy and provide choice for taxpayers e.g. monthly payments spread over 12 months or tax collected by the employer each month before the salary is paid

4. **Efficient:** the management of the tax system by the government should not be overly expensive or wasteful

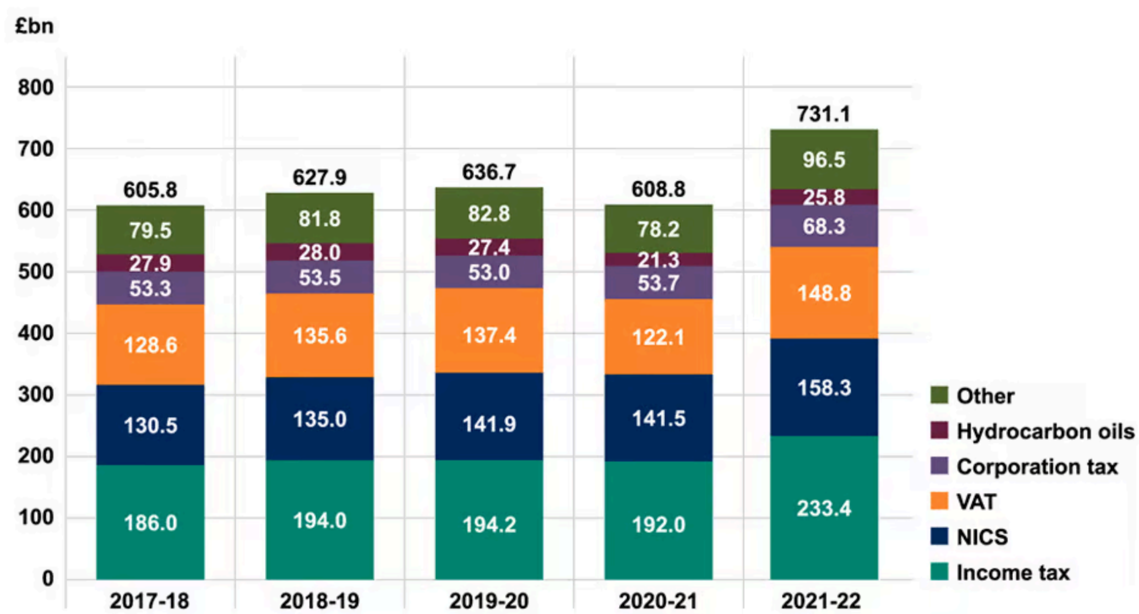
5. **Fit for purpose:** there should not be any unintended side effects of the system, e.g. disincentivising workers from working

6. **Flexible:** it should be easy to adjust/change as required by changes in the economy

The Role & Relative Merits of Different UK Taxes

- The tax system of a country determines **who pays the most**
  - In the UK, corporations pay less than households
  - In Singapore, households pay less than corporations

Graph: source of UK revenue by taxation type 2017-2022



Your notes

Your notes

Households have to pay VAT, Income tax, national insurance contributions (NICs)
Source: www.gov.uk

Role and Merit of Different UK Taxes

Direct taxes	Indirect taxes
▪ In the UK, **income tax** is collected by the government through 'pay as you earn' **(PAYE)** ▪ Income tax is **cheap** to collect, **convenient** and **certain** for the taxpayer ▪ It is **equitable** as it reflects taxpayers' ability to pay ▪ As tax rates rise, it increases the **disincentive** to pay tax which creates an **incentive** to **reduce hours worked** ▪ The **marginal rates of tax** should not discourage workers from working overtime ▪ It also lead to a **brain drain** as people leave the country in order to find countries with more generous tax systems ▪ It is debatable whether or not increasing **top rate taxes** on income raises extra revenue, or whether it may result in less money being collected	▪ Value Added Tax (**VAT**) is levied on the sale of goods and services. It accounts for roughly 20% of tax revenue ▪ The **costs** of collection is placed on traders / retailers and not the state. The revenue collected is much greater than the costs of collection ▪ They are harder tax to evade as the tax is built into the selling price they are impossible to **evade** ▪ As they are included in the selling price, they are **convenient** for the taxpayer ▪ VAT does not take a person's ability to pay into account and so the burden falls more heavily on lower income groups ▪ With rising prices it may be a **disincentive to spend**
▪ **Capital and wealth taxes** are considered to be progressive taxes and have the potential to reduce inequality and generate a high level of government revenue ▪ It could discourage the accumulation of large levels of wealth ▪ However, it could act also as a disincentive to declare wealth/capital and tax avoidance / evasion may occur. ▪ There is a risk that they could also discourage the honest declaration of wealth	▪ **Excise duties** are levied on **demerit goods** such as tobacco, alcohol, sugar ▪ They are always *specific* or *unit taxes*, levied on the physical quantity of the good ▪ This tax would bring in much needed **revenue** for the government that could help fund health initiatives ▪ It could be programmes which fund education on health impacts and act as

and lead to tax avoidance or evasion	a disincentive to consume these demerit goods ▪ May lead to **hidden market** economy activities leading to a loss of revenue for the state

Your notes

Fiscal Policy: Budget Balances & National Debt

Your notes

The Budget Balance & National Debt

- The **Government Budget (**Fiscal policy) is presented each year as a balanced budget, a budget deficit, or a budget surplus
  - A **balanced budget** means that **government revenue** = **government expenditure**
  - A **budget deficit** means that **government revenue** < **government expenditure**
  - A **budget surplus** means that **government revenue** > **government expenditure**
- A **budget deficit** has to be financed through **public sector borrowing**
  - This borrowing gets added to the **national debt** (the cumulative total of past government borrowing which has to be repaid with interest)
  - **Keynesian economists** believe that the government should **'run a budget deficit**' to finance spending and stimulate economic growth
    - However, this increasing debt puts a greater burden on the population that will have to repay it in the future

Cyclical & Structural Budget Deficits & Surpluses

- A **cyclical** budget deficit or surplus is related to the **economic cycle** and **aggregate demand**
  - During a **boom,** there is an improvement in the **government budget** as tax revenues rise and expenditure falls, decreasing the deficit
  - During a **recession,** there is an increase in government expenditure, leading to a greater **budget deficit**
    - A cyclical deficit could then be corrected when the economy recovers again through the impact of **automatic stabilisers**
- A **structural budget** focuses on the **long-term underlying fiscal position of the government,** independent of the effects of the business cycle
  - It aims to assess whether **government revenues are sufficient to cover ongoing expenditures** over the long term, without considering temporary fluctuations in economic activity
  - Structural budget analysis often involves evaluating the sustainability of government policies and the need for fiscal adjustments to ensure long-term fiscal stability
  - For example, an increase in an **ageing population** will require the government to spend more on pensions and healthcare

Your notes

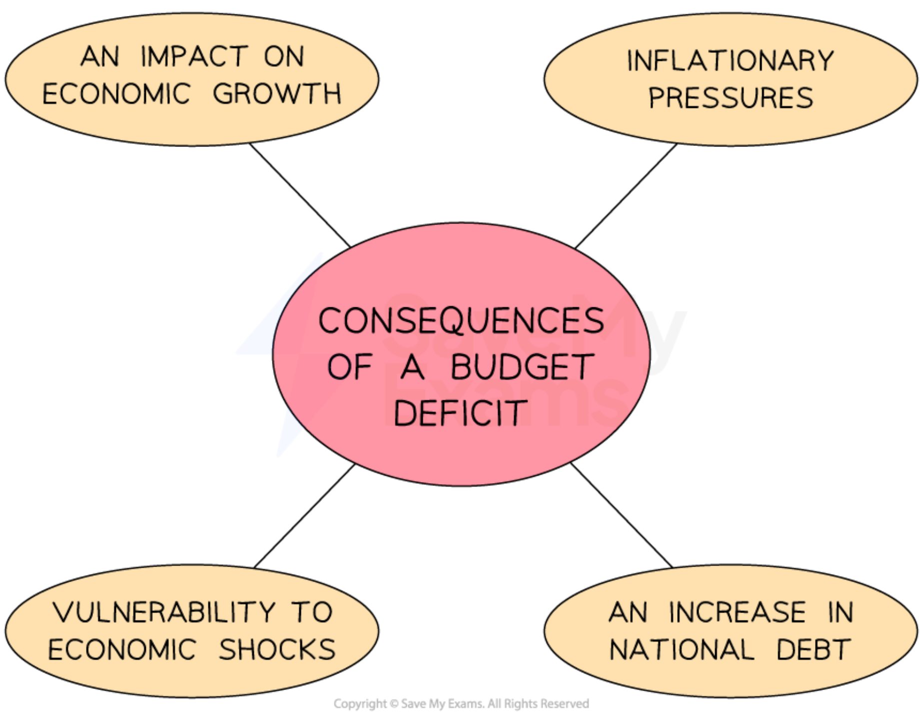
- If this expenditure is greater than revenue, it is added to national debt and is called a **structural budget deficit**
- Correcting a structural budget deficit resulting from excessive borrowing is challenging
- Governments need to **increase taxes** and **cut public spending** (austerity measures) which can negatively impact economic growth and employment

Consequences of Budget Deficits & Surpluses

Consequences of a Budget Deficit

- Many countries continue to run a budget deficit year after year
  - A deficit must be financed through borrowing from somewhere
    - Borrowing from **outside the country (external borrowing)** may cause political vulnerabilities
    - Singapore only borrows from its **own citizens (internal borrowing)**, which reduces the risk of external pressure on their policies

Diagram: Consequences of a Budget Deficit



Running a budget deficit enables a government to spend more than it receives

Your notes

Explaining the Consequences

Consequences of a Deficit	Explanation
National debt increases	▪ **National debt** rises as the government spends more than it takes in. This money has to be paid back with interest ▪ There is a burden on **future generations,** as they are left with large interest payments on the debt ▪ This creates an **opportunity cost** as future governments may have to cut spending on services, in order to repay the debt
Inflationary pressures	▪ A deficit can cause the economy to **overheat,** as governments spend more money (injects more than it withdraws) ▪ This causes **demand pull inflation**, as there is more money in circulation
Economic shocks	▪ The economy is more vulnerable to **economic shocks** ▪ If there is no surplus set aside in the event of a shock (e.g. Covid), then the ability to respond is limited

Economic growth	▪ If the borrowing is to be spent as increased government spending, the economy may benefit in the short to medium term
	  ▪ However, more borrowing may cause inflation, which can lead to a **rise in interest rates** to curb that inflationary pressure
	  ▪ Higher interest rates will **discourage investment** by firms and also cause the nation's currency to appreciate, meaning that its exports are less price competitive
	▪ In the longer term, fewer investments and exports, together with higher interest payments on the debt, may cause AD to fall and lead to lower levels of **economic growth**

Consequences of a Budget Surplus

- A **budget surplus** can be used to reduce general government debt and reduce future costs of servicing the debt
  - A surplus can be set aside for future economic shocks e.g. the Covid 19 crisis

- However, a surplus may mean that the government **withdraws** (higher taxes) more money than it **injects** (less spending)
  - A surplus may then reduce economic growth and also reduce pressure on prices levels leading to disinflation or even deflation

The Significance of the Size of the National Debt

- A **budget deficit** has to be financed through **public sector borrowing**
- This borrowing gets added to the **national debt**
  - The size of the UK's national debt increased significantly during the Covid pandemic

Debt to GDP Ratio

- A **Debt to GDP** ratio measures the size of a country's debt in relation to size of the country's economy
  - A **high Debt to GDP** ratio creates vulnerabilities

The Significance of Large National Debt

Implication	Explanation
Cost	▪ A growing national debt results in higher annual **cost** of repaying national debt plus paying interest ▪ The increase will prompt the government to raise taxes for future taxpayers Increasing the **burden on future generations**
Opportunity costs	▪ With more government income being used to meet our annual interest repayments, the government has **less funds** available ▪ The Government will have to cut back spending on certain **public services** ▪ E.g. Health care, education, infrastructure
Diminished international credit-rating	▪ An increasing national debt means that UK's **credit-rating** is deteriorating ▪ This may cause firms and foreign countries to **stop lending money** to UK ▪ This will constrain the country's ability to grow in future.

Your notes

Your notes

Crowding out	▪ When governments borrow money, they do so by selling **bonds** (treasury bills) to people who want to save ▪ This increases demand for savings and in turn increases **interest rates** ▪ A higher interest rate reduce incentive to borrow by firms/consumers ▪ Resulting in reduced aggregate demand

The Role of the Office for Budget Responsibility

- The **Office for Budget Responsibility** (OBR) was established in 2010
- The primary responsibility of OBR is to manage **public sector finances**
- Other responsibilities include:
  - Providing detailed forecasts on the current **economic performance**
  - An analysis of UK **public spending** and **taxation**
  - Assesses the performance of the government against the fiscal targets set
  - Advises government on **economic predictions** to aid with future policymaking
  - Uses long-term projections to analyse **sustainability** of government spending and revenue

Your notes

An Introduction to Supply-side Policies

Introduction to Supply-side Policy

- **Supply-side policies** aim to shift the long-run aggregate supply (LRAS) outwards, increasing the productive potential of the economy
- "There are two categories of supply-side policies
  - **Interventionist policies**
  - **Free market policies**
- Market based supply side policies can create conditions in which firms thrive and are incentivised to **generate supply-side improvements**

The Distinction Between Supply-side Policy and Supply-side Improvements

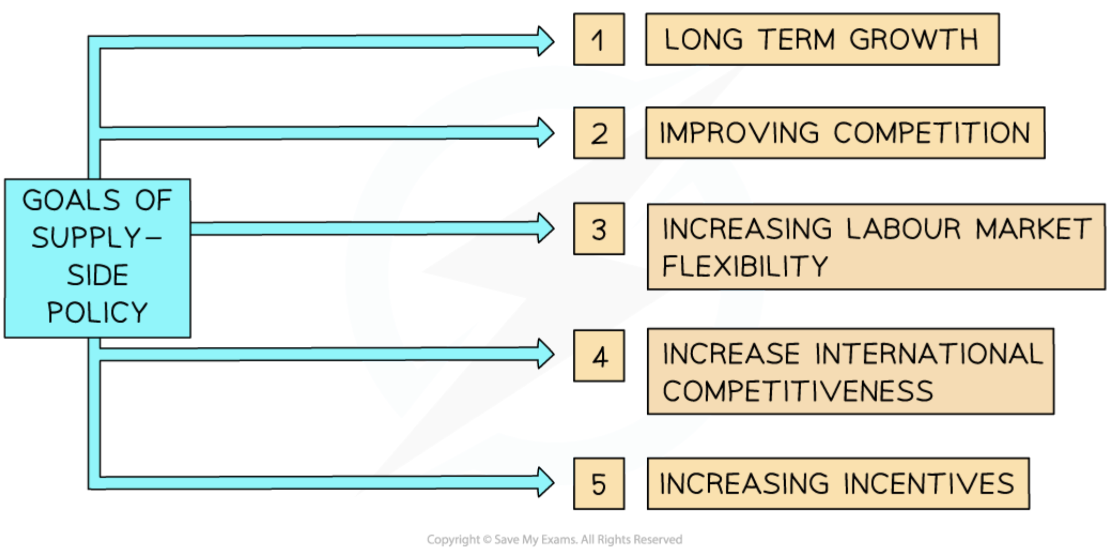
	Supply-side Policy	Supply- side Improvements
Definition	▪ Government policies aimed at increasing the production capacity of the economy ▪ Achieved by by focusing on factors that affect the supply side, such as labor, capital, technology, and entrepreneurship	▪ Specific actions made by firms within the supply side of the economy to enhance its performance and efficiency
Objective	▪ Influence the macroeconomic environment and structural conditions of the economy to promote long-term growth and competitiveness	▪ Enhance efficiency, quality, and competitiveness within individual firms or sectors
Examples	▪ Tax cuts, deregulation, investment in education and training, subsidies for research and development, and infrastructure development	▪ Firms adopt new production techniques, invest in advanced machinery, implement quality control measures, streamline supply chains, enhance worker skills through training programs etc.
Scope	▪ Broad range of government interventions aimed at shaping the	▪ Actions taken by firms, industries, or markets to boost efficiency and

	overall economic environment	productivity
Agency	▪ Typically involves government intervention and policymaking.	▪ Can be driven by various agents, including businesses, workers, consumers, and technological advancements

Your notes

The Goals of Supply-side Policy

- Supply-side policies can be extremely useful in **generating long term trend growth**, lowering average price levels, and creating new jobs in an economy



The five goals of Supply-side policy

- When successful, **supply-side policies** have the following effects on the **government's macroeconomic objectives:**

Supply-side Policies and the Macroeconomic Objectives

Impact of Supply-Side Policies	Explanation

Economic growth	▪ The potential national output increases, leading to higher **real gross domestic product (rGDP)**
Unemployment	▪ Supply-side policies **reduce labour costs** and create **labour market flexibility** through: ▪ Decreasing **trade union powe**r so wages can be decreased ▪ Decreasing or abolishing minimum wages to lower costs of production ▪ Restructuring the unemployment benefits system to **incentivise** the unemployed to seek work
Inflation	▪ Supply-side policies reduce **average price levels** ▪ By deregulating the market and reducing taxes, it reduces businesses' costs of production there will be less **cost-push inflation** ▪ **Demand-pull inflation** could also be reduced as potential capacity of economy increases (PPC curve shifts outwards)
Balance of payments	▪ Supply side policies such as Increased spending on innovation and direct support to firms (subsidies) promotes international competitiveness ▪ This can increase the value of **net exports** ▪ An increase in export demand from abroad causes the balance of payments on the **current account to improve**

Your notes

The Role of Supply-side Policies in Reducing the Natural rate of Unemployment

- Supply-side policies play a crucial role in **reducing the natural rate of unemployment** by addressing structural issues within the labour market
- The natural rate of unemployment (NRU) refers to the level of **unemployment that exists in an economy when it is operating at full potential** or potential output
  - It includes **frictional** and **structural** unemployment but excludes **cyclical** unemployment, which fluctuates with the business cycle

Here's how Supply-side Policies Reduce the NRU

Why it reduces the NRU	Explanation
Enhances labour market flexibility	▪ Labour market deregulation, flexible work arrangements, and reducing barriers to entry into professions **increase the flexibility of the labour market** ▪ This flexibility allows workers to more easily **transition between jobs,** and reduces frictional unemployment
Investment in human capital reduces structural unemployment	▪ Education and training systems enhance the skills of the workforce ▪ A more skilled workforce is better equipped to meet the demands of a changing economy, which **reduces structural unemployment**
Encouraging entrepreneurship and innovation creates new jobs	▪ Policies such as tax incentives for research and development (R&D), subsidies for small business create new job opportunities, thereby reducing unemployment.
Lowering barriers to employment reduces frictional unemployment	▪ Cutting red tape for businesses, lowering taxes on labour, and implementing targeted employment subsidies, encourage hiring and labour force participation ▪ More people **enter the labour market**, reducing the natural rate of unemployment.
Promoting investment and economic growth can reduce structural and frictional unemployment	▪ Tax cuts for businesses, deregulation, infrastructure investment, and trade liberalisation, stimulate investment and economic growth ▪ A growing economy **generates more job opportunities** and reduces unemployment over the long term

Your notes

Types of Supply-side Policies

Your notes

Free Market Supply-side Policies

- Free market based supply-side policies aim to **free up markets** and improve market incentives so as to increase the long-run aggregate supply

An Explanation of Free Market Supply-side Policies

Market based policy	Explanation	Possible effects on the aims of supply-side policy
To increase incentives	▪ Reducing **income/corporation tax** rates incentivises workers to work harder (they keep more money for themselves) and provides firms with extra funds which they can use to invest in new machinery/technology ▪ Reducing **capital gains tax**	Taxes decrease → firms and individuals retain more money for themselves → incentives increase → productivity improves → long term growth increases
To improve competition and efficiency	▪ **Deregulation.** Any regulation increases costs of production for firms and deregulation decreases costs which may result in greater supply ▪ **Privatisation**. Government firms are usually so big that private enterprise refrains from trying to compete with them. Privatisation encourages new firms to enter the market and compete, thus increasing the **aggregate supply** in the economy ▪ **Anti-monopoly regulation** helps to increase competition in an economy which leads to a more efficient allocation of resources	Regulation on firms decreases → the cost of production for firms falls → firms lower selling prices → international competitiveness improves State owned firms are privatised → more firms enter the market to compete → competition and efficiency improves

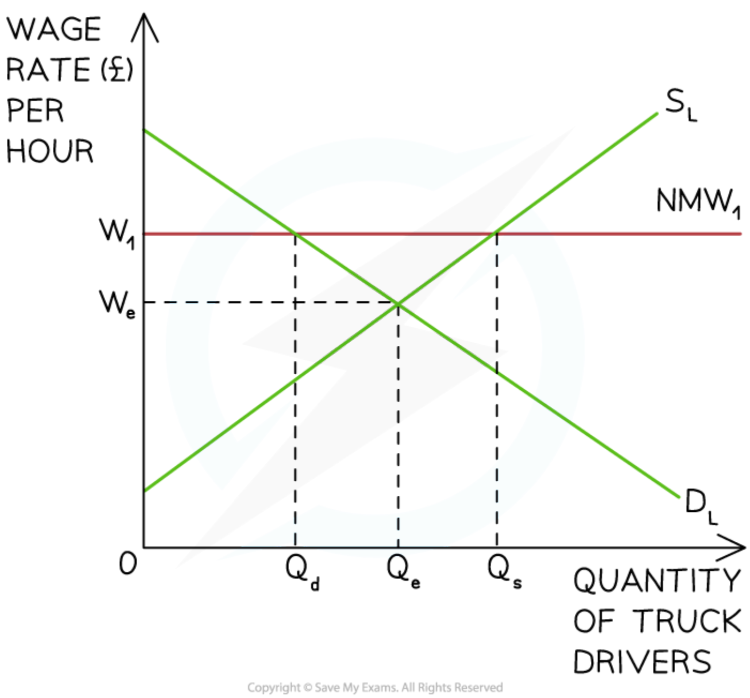
To reduce labour costs and create labour market flexibility	▪ Decreasing **trade union power** so wages can be decreased ▪ Decreasing or abolishing **minimum wages** to lower costs of production ▪ Restructuring the **unemployment benefits** system to incentivise the unemployed to seek work	Wages decrease → the cost of production for firms falls → firms lower selling prices → international competitiveness improves

Your notes

The possible impact of abolishing minimum wages

- A **national minimum wage (NMW)** is a **legally imposed wage level** that employers must pay their workers
  - It is set **above** the market rate
  - Removing it will allow wage levels to fall, thus **reducing the costs of production** for firms

Diagram: Abolition of a Minimum Wage



Removing the national minimum wage (NMW_1) may cause wage rates to fall from W_1 to W_e

Your notes

Diagram analysis

- The **demand for labour (D_L)** represents the demand for workers by firms
- The **supply of labour (S_L)** represents the supply of labour by workers
- The **national minimum wage** and quantity for truck drivers in the UK is seen at **W_1Q_d**
- The UK government removes the **national minimum wage** (NMW) at **W_1**
- Incentivized by lower wages, the **demand for labour by firms increases** from $Q_d \rightarrow Q_e$
- Facing lower wages, the **supply of labour** by workers **decreases** from $Q_d \rightarrow Q_e$
- The labour market is now in equilibrium at W_eQ_e
  - There is a lower wage rate and **higher quantity of workers employed**

Evaluating free market supply-side policies

- The benefits of supply-side policies far **outweigh the negatives**, yet many economies fail to fully develop their supply-side policies due to a process of constant political change and an associated change in government priorities

An Evaluation of Free Market Supply-side Policies

Advantages	Disadvantages
▪ **Improved resource allocation:** increasing the productive capacity of an economy requires more efficient use of its resources, including labour ▪ **No burden on government budget:** with an emphasis on freeing up markets and allowing market forces to drive efficiency and resource allocation, there is no requirement for government spending	▪ **Equity issues:** E.g. the distribution of income worsens as labour market reforms and wage policies lower worker's wages ▪ **Time lags:** there are significant time lags between expenditure and seeing the benefits ▪ **Vested interests:** can result in less effective outcomes, e.g. there are many examples of privatisation occurring in such a way that the government's preferred bidders obtained an **asset at a knock down price** ▪ **Environmental impact:** large infrastructure projects almost always have some negative externalities associated with their creation e.g. dam in a gorge to create a hydro electric dam damages the natural environment and eco system

Your notes

Interventionist Supply-side Policies

- Interventionist supply-side policies require **government intervention** in order to increase the **full employment level of output**

An Explanation of Interventionist Supply-side Policies

Supply-side Policy	Explanation	Possible effects on the aims of supply-side policy
Education and training	▪ Increasing government spending on **education** and retraining raises the quality of the workforce resulting in productivity improvements	Skill level increases → productivity improve → the cost of production for firms falls → firms lower selling prices → international competitiveness improves
Improving quality, quantity and access to health care	▪ Increasing government spending on **healthcare** so that productivity improves	Human capital improves → productivity improves → the cost of production for firms falls → firms lower selling prices → international competitiveness improves
Research and development	▪ Increased **government spending** on innovation increases the supply of potential jobs in the economy	A new industry emerges → new infrastructure is developed → more jobs are created → r.GDP increases → increase in long term economic growth
Provision of infrastructure	▪ Increased government spending on infrastructure helps to facilitate the **movement of people and goods** which increases the aggregate supply	New infrastructure is developed → costs of production decrease → supply increases → firms lower selling prices → international competitiveness improves
Industrial policies	▪ Industrial policies are direct and targeted support to firms or industries in the form of **subsidies**	Industries receive subsidies → costs of production decrease → supply increases → firms lower selling prices → international competitiveness improves

Evaluating interventionist supply-side policies

An Evaluation of Interventionist Supply-side Policies

<table>
<tr><th>Advantages</th><th>Disadvantages</th></tr>
<tr><td>

Direct support of sectors important for growth: Subsidies to specific industries increase the rate of growth of an economy

Direct support reduces unemployment
Direct support can increase the level of exports

Improvements in living standards: Improvements in Infrastructure can raise the quality of life for all citizens

</td><td>

Costs: they are expensive to implement and are paid for using tax revenue - or increased government borrowing
Time lags: due to their long-term nature, changes in government often result in changes to budgets and scope of projects and the end result may be less effective than it could have been

The cancellation of the High Speed Rail project in the UK is an example of this

</td></tr>
</table>

Examiner Tips and Tricks

Essay questions will test your ability to differentiate between market-based and interventionist supply-side policies.

When evaluating supply-side policies in essay responses, demonstrate critical thinking by acknowledging that privatisation has been used for so long that there are often relatively few assets left to privatise, and perhaps a better way forward is to improve competition policy and regulation. Draw on the real-world examples and effectiveness of such policies: for example, has privatisation worked in all markets such as railways?

Remember, the private sector will also be increasing supply in an economy (it is not only up to the government) as they are incentivised to increase their profits.

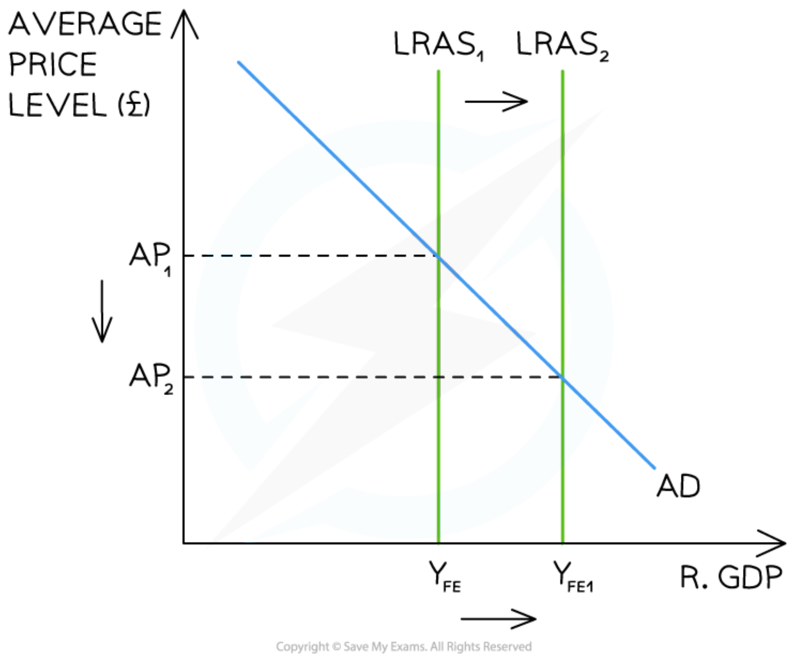
Use diagrams to illustrate your essay responses and draw upon real-life examples so that your critical thinking is demonstrated in context of some of the major issues facing the UK economy.

Diagrams to Illustrate Supply-side Policies

- Successful supply-side policies will increase the **long-run aggregate supply (LRAS)**

- This equates to an increase in the production possibilities of an economy

Diagram: The Impact of Successful Supply-side Policies



A AD/AS and LRAS diagram that illustrates the implementation of a successful supply-side policy

Diagram analysis

- Efforts to reduce **trade union power** have been successful
  - There is now less protection on wage levels and **wage levels fall**
- Firms may **hire more workers** and the **quantity of productive labour** in the economy has increased
  - This causes $LRAS_1$ to increase to $LRAS_2$
    - **Output increases** from Y_{FE} to Y_{FE1}
    - Average **price levels** fall from $AP_1 \rightarrow AP_2$

Your notes