

Chapter 32 Supply-side policy

Answers to Knowledge checks

- 32.1** If managers are not fully accountable for their actions, they may become complacent, which could lead to inefficiency. They may also be able to pursue their own objectives, as was explained in Chapter 12.
- 32.2** Human capital is the stock of skills and expertise that contribute to a worker's productivity, as explained in Chapter 18.
- 32.3** If firms realise that trained workers may be poached by rival firms, they may be reluctant to spend on training. From the government's perspective, this reduces the flexibility of the labour market, so it is a form of market failure that can be addressed if firms can be encouraged to change their attitude.
- 32.4** In a contestable market, a monopoly firm will charge a price equal to average cost to ensure that other firms no longer have an incentive to join the market (because the monopoly will not be making supernormal profits). Contestable markets are discussed in Chapter 15.
- 32.5** When managers are accountable to a multitude of shareholders, the degree of accountability may be low. Managers may then be able to pursue their own objectives as long as they make enough profit to keep their shareholders satisfied. For example, they may choose to maximise their utility, or to maximise market share.

Answers to Exercises and Case studies

Exercise 32.1

Under neoclassical assumptions, the *LRAS* curve is vertical at the full employment level, as shown in Figure A32.1. If there is an increase in *LRAS*, the equilibrium full employment level increases from Y_{FE0} to Y_{FE1} , and if aggregate demand remains unchanged, the overall price level falls from P_0 to P_1 .

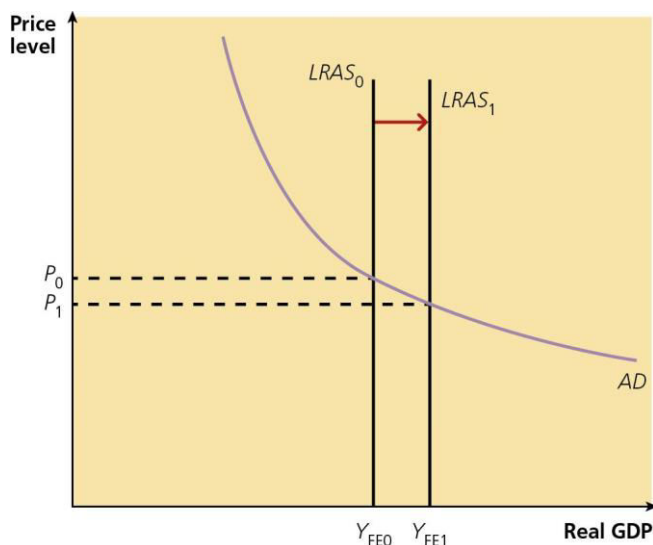


Figure A32.1 An increase in *LRAS* under neoclassical assumptions

Under Keynesian assumptions, if the initial equilibrium is below full employment, the effect is different, as shown in Figure A32.2. Initially, equilibrium is at Y_0 with a price level at P_0 . The

rightward shift in the $LRAS$ curve results in a higher equilibrium real GDP at Y_1 and a lower overall price level at P_1 . Notice that the equilibrium level of real GDP remains below the (new) full employment level after the change.

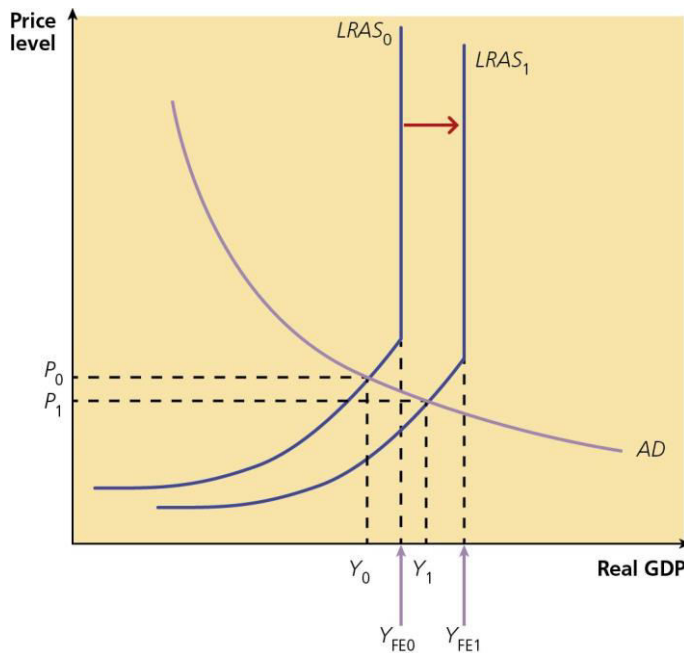


Figure A32.2 An increase in $LRAS$ under Keynesian assumptions

Exercise 32.2

The key issue for debate here is how to balance the future benefits of improving the road network against the present benefits of improving the NHS. People need healthcare in the present, but improving the road network would help to keep British firms competitive by reducing transport costs in the future.

Exercise 32.3

- a An increase in government expenditure is primarily an example of **fiscal policy**. By increasing expenditure, the government can influence the position of the aggregate demand curve. However, if such a policy is introduced when the economy is already at full employment, the only effect of rising government expenditure will be to increase the overall price level in the economy. Some types of expenditure could also be part of **supply-side policy**, for example if there is spending on retraining of workers.
- b A decrease in the rate of unemployment benefit (*ceteris paribus*) will encourage higher labour force participation, as some workers who previously have chosen to live on benefit will find work more attractive. This constitutes a **supply-side policy**, as it directly affects aggregate supply — with more workers in the labour force, the productive capacity of the economy is increased. The effects can be seen in Figure A32.3: an increase in productive capacity associated with a rightward shift of the aggregate supply curve from $LRAS_0$ to $LRAS_1$ leads to an increase in real output from Y_{FE0} to Y_{FE1} , and a fall in the general price level, from P_0 to P_1 .

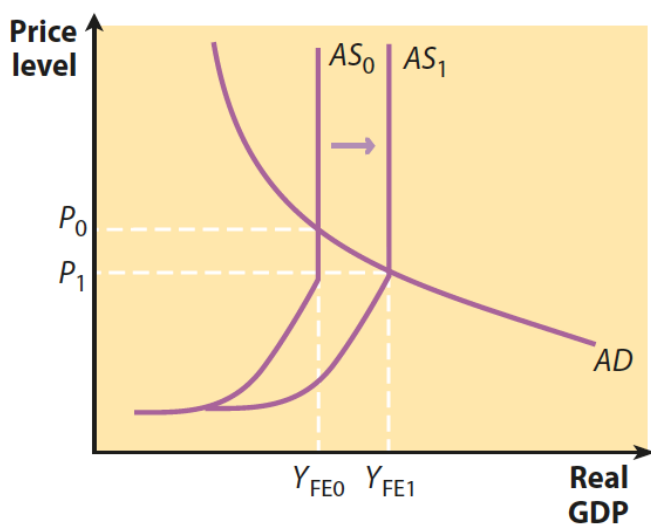


Figure A32.3 A shift in aggregate supply

- c** A fall in the rate of interest is an example of **monetary policy**. A fall in the interest rate is seen as a fall in the cost of borrowing, and can be expected to encourage higher spending by households and higher investment by firms. In the short run, this means a movement of the aggregate demand curve to the right, and an increase in equilibrium real output and the general price level. The extent to which the effect is felt in output and prices will depend upon whether or not the economy begins at full employment. In the long run, a higher level of investment by firms will lead to an increase in productive capacity, and a rightward shift of the aggregate supply curve.
- d** Legislation to limit the power of trade unions is a **supply-side policy**, which improves the flexibility of the labour market and therefore increases the productive capacity of the economy, shifting aggregate supply to the right.
- e** Encouraging more students to attend university is a **supply-side policy**. The expectation is that in the long run, students with a university degree will be more productive in the labour force, thereby raising the productive capacity of the economy and shifting aggregate supply to the right.
- f** Retraining in the form of adult education improves the flexibility of the labour market and helps to reduce structural unemployment. It is therefore a **supply-side policy**, which will increase the productive capacity of the economy and shift aggregate supply to the right. The provision of such retraining also entails government expenditure, so there would be a side effect on aggregate demand.
- g** A reduction in the highest rate of income tax may be seen as an example of **fiscal policy**, to the extent that it increases salaries of high-income earners and leads to an increase in consumption — and therefore in aggregate demand. However, the impact of this may be limited, as high earners tend to have a relatively high propensity to save. More important may be the incentive effects of reducing marginal tax rates to high-income earners. If the change encourages a higher level of labour input, it raises the productive capacity of the economy and shifts aggregate supply to the right. In this case, the measure is an example of a **supply-side policy**.
- h** Measures to break up a concentrated market are intended to reduce the extent to which firms abuse their monopoly power in a market by restricting output and raising price in order to maximise profits. If successful, this will improve allocative efficiency in the economy, raising the productive capacity and shifting aggregate supply to the right. It can therefore also be regarded as an example of a **supply-side policy**.

- i The bank rate is the interest rate used as a policy instrument by the Bank of England. An increase in the bank rate is therefore an example of **monetary policy**, and will have the effect of reducing aggregate demand. In other words, this is answer (c) in reverse.

Case study 32.1

Macroeconomic policy instruments

Monetary policy operates in the UK through the MPC — the Monetary Policy Committee of the Bank of England, which was given independent power to use monetary policy to hit the government's inflation target in 1997. In essence, the Bank operates by manipulating the bank rate, therefore influencing interest rates in the economy, which in turn affects aggregate demand by influencing investment and consumption expenditure. There are also indirect effects that work through the exchange rate. Maintaining macroeconomic stability is seen as fundamental for the economy, as this provides a stable environment within which economic growth can be achieved. A key argument here is that stability in the macroeconomy encourages investment by firms, which then raises the productive capacity of the economy.

Fiscal policy operates through the government's spending and taxation, which together determine the government's budget. It is thought that too active a government will be potentially damaging by crowding out the private sector. Where the private sector is more efficient (productively) than the public sector, this would damage the long-run economic growth prospects for the economy. Hence, the need to maintain a balance between the private and public sectors. A balance between present and future generations is also sought. The idea here is that government borrowing (which has to be paid back by future generations) should be restricted to acts of investment that will benefit that future generation. Present consumption should be financed by the present generation.

Supply-side policies use microeconomic incentives to affect the productive capacity of the economy, therefore promoting economic growth directly.

It is not possible to say that one type of policy is more important than the others. They each set out to achieve a different set of objectives, all of which are important to the modern economy. The important thing is to keep an appropriate balance between them in order that the economy follows the best possible path into the future.

Answers to end-of-chapter questions

A Multiple-choice questions

- 1 d. Government spending on benefits
- 2 d. Deregulation of a large industry

B Knowledge and understanding questions

- 3 Supply-side policies are a range of measures intended to have a direct impact on aggregate supply — and specifically the potential capacity output of the economy.

A full explanation of supply-side policies	2 marks
A vague or partial explanation of supply-side policies	1 mark

- 4 An increased government focus on education can affect the macroeconomy by causing an increase in *LRAS*, leading to an increase in long-run economic growth (the potential growth of an economy) and possibly both an increase in real GDP and a reduction in the price level.

An explanation of how an increased government focus on education can affect the macroeconomy	up to 2 marks
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A diagram of how an increased government focus on education can affect the macroeconomy	up to 2 marks
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- 5 Privatisation may lead to an increase in productivity, leading to an increase in LRAS and in long-run economic growth. This could increase real GDP and lead to a possible reduction in the price level.

An explanation of how privatisation may affect aggregate supply in an economy	up to 2 marks
A diagram of how privatisation may affect aggregate supply in an economy	up to 2 marks

D Essay question

6

AO1 Knowledge	3 marks
AO2 Application	4 marks
AO3 Analysis	6 marks
AO4 Evaluation	7 marks

Knowledge (3 marks) likely to include:

- Supply-side policies, including:
 - Privatisation and deregulation
 - Improved labour market flexibility
 - Reforms of the tax and benefit system
 - Investment in infrastructure, education, training, research and development
 - Subsidies
 - Competition policy
 - Immigration control

Application (4 marks) is likely to include:

- Application to the achievement of economic growth

Analysis (6 marks) is likely to include:

Analysis of supply-side policies, for example:

- An increase in *LRAS*, leading to a possible increase in real GDP and a possible decrease in the price level

Evaluation (7 marks) is likely to include:

Evaluation that supply-side policies may not achieve economic growth, for example:

- An increase in *LRAS* may not lead to an increase in real GDP (or effect the price level) if there is a negative output gap
- Depends upon the effectiveness of the policy
- Depends upon the state of the macroeconomy

A judgement of the effectiveness of supply-side policies to achieve the economic growth