

Macroeconomic policy

In this final centrespread about macroeconomic policy, Peter Smith highlights the key aspects of supply-side policy

What is supply-side policy?

- Economic growth is a fundamental aim of macroeconomic policy.
- Economic growth arises from an increase in the factor inputs available in the economy and the efficiency of use of those factors.
- These affect long-run aggregate supply.
- Supply-side policies attempt to influence long-run aggregate supply directly.
- Such policies depend upon microeconomic rather than macroeconomic measures.
- Incentive effects are especially important in the design of supply-side policies.

Influencing long-run aggregate supply

- Supply-side policies are designed to induce a rightward shift in long-run aggregate supply (LRAS), as shown in Figure 1.
- LRAS shifts to the right, from $LRAS_0$ to $LRAS_1$, resulting in an increase in the full-employment level of real output, from Y_{FE0} to Y_{FE1} .
- As drawn in the figure, the initial equilibrium shows the economy at full-employment equilibrium, so the result is an increase in real output and a lower equilibrium price level.
- Had the initial equilibrium been below full employment, the result would still have been a rise in real output.

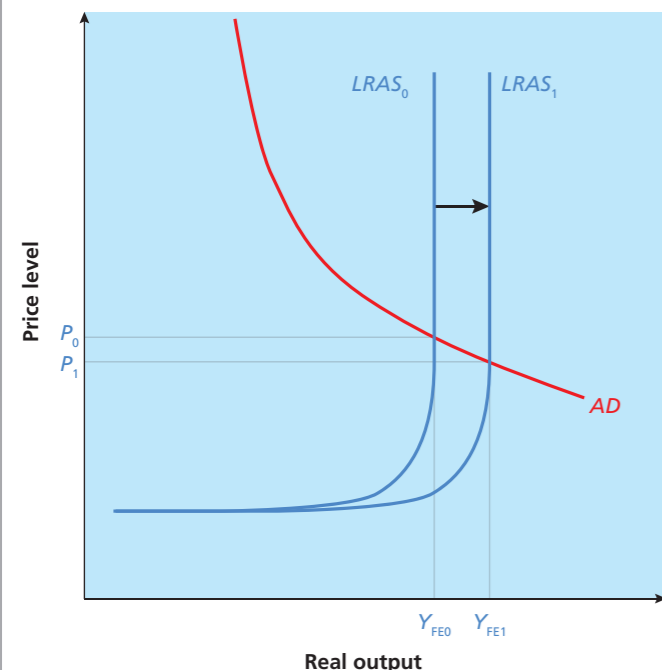


Figure 1 A shift in long-run aggregate supply

Market-based vs interventionist policies

- In discussing supply-side policies, it is useful to distinguish between two different approaches to influencing long-run aggregate supply.
- One approach is market-oriented, which relies on improving how markets work.
- If markets work effectively, resources in the economy will be used efficiently.
- A second possibility is to adopt an interventionist approach.
- This entails intervening directly to influence the allocation of resources to affect aggregate supply.

Privatisation and regulation

- Natural monopolies present challenges, and in the past nationalisation (state ownership) was seen as a solution.
- This proved to be less than successful, as state ownership did not offer the best incentives for managers to work efficiently.
- Privatisation (the transfer of state-owned enterprise into the private sector) is one way of allowing market forces to have a stronger role in resource allocation, which could lead to an increase in aggregate supply.
- However, regulation became important in privatised activities, to ensure that efficiency gains could be achieved and a good allocation of resources consolidated.
- This suggests that this approach represents a combination of market-oriented measures but with some interventionist input.

Reforming the labour market

- It is important for any economy that labour markets work efficiently.
- This allows workers to move between sectors as the pattern of consumer demand changes through time, and prevents unemployment from becoming higher than it needs to be.
- There are several ways in which labour markets do not operate as effectively as possible.
- Minimum wage legislation and regulations on redundancy, etc., are in place to protect vulnerable groups, but a balance needs to be found between such protection and restrictions on the flexibility of labour markets.
- Trade unions may hold labour markets away from equilibrium or cause disruption, as occurred in the strikes of 2023. A balance needs to be found between allowing unions to protect the interests of their members and ensuring that labour markets operate effectively.
- Flexibility in labour markets enables price signals to be effective in allocating resources.
- These are market-oriented supply-side policies.

Reforming taxes and the benefits system

- Labour supply is influenced by incentives.
- High taxes may deter the supply of labour effort.
- Raising the highest rate of income tax may provide revenue to be used to benefit poorer groups, but may disincentivise high earners.
- High social security benefits may affect an individual's decision about whether to take a job.
- If an individual receives benefits in excess of what can be earned in a low-paid job, there may be little incentive to accept a job.
- Again, it is important to keep a balance between providing enough protection for the poor and providing incentives for people to supply labour.
- This is an important way in which labour markets can be made to work effectively, and hence affect aggregate supply.

Infrastructure

- Another example of an interventionist approach is where the government invests in developing infrastructure.
- This may include spending on roads, communication systems and other types of social infrastructure.
- For example, by improving the road system, firms face lower transportation costs, making them more competitive.
- Government intervention in providing and improving infrastructure addresses the market failure that arises because of its public goods characteristics.
- Investment in the HS2 rail links was intended to help to 'level up', affecting the competitiveness of firms in the north of the country.
- However, this project has become contentious because of the size of the expenditure and the potential damage to the environment.

Promoting competition

- The basis of the market-oriented approach to supply-side policy is that markets should operate effectively wherever possible.
- The promotion of competition between firms is crucial to this strategy.
- The theory of the firm argues that a firm with market power will look to restrict output and raise price to maximise profits.
- The Competition and Markets Authority (CMA) has powers to investigate markets where the action of powerful firms may be used against the public interest by stifling competition.
- The intensity of competition between firms provides strong incentives for firms to be innovative and to find ways of improving productivity.
- For this reason, policies that encourage competition between firms can affect aggregate supply.

Tackling information failure

- Information failure is a form of market failure.
- One example is in labour markets, where workers may not have good information about the availability of jobs.
- During the Covid-19 pandemic, information needed to be provided to encourage the take-up of vaccines, in order to bring the virus under control.
- In the case of demerit goods, people may not fully perceive the true social costs of consuming certain goods, such as tobacco or other drugs.
- In all of these (and similar) situations, an important way of tackling the market failure is by providing the information that is lacking.
- This again can have the effect of improving the way in which markets work and hence stimulating aggregate supply.

Education and training

- A key component of economic growth is the quality of the workforce.
- Education and training is seen as investment in human capital, by improving the skills and ability of workers.
- Many firms offer training to their workers, but if they are aware that trained workers may be poached by other firms they are likely to offer less training than is optimum.
- This is a form of market failure that may be tackled by government training schemes.
- Such schemes may be aimed at young workers, or at workers made redundant from sectors that are in decline.
- This is one way in which an interventionist approach may affect aggregate supply while tackling market failure.

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