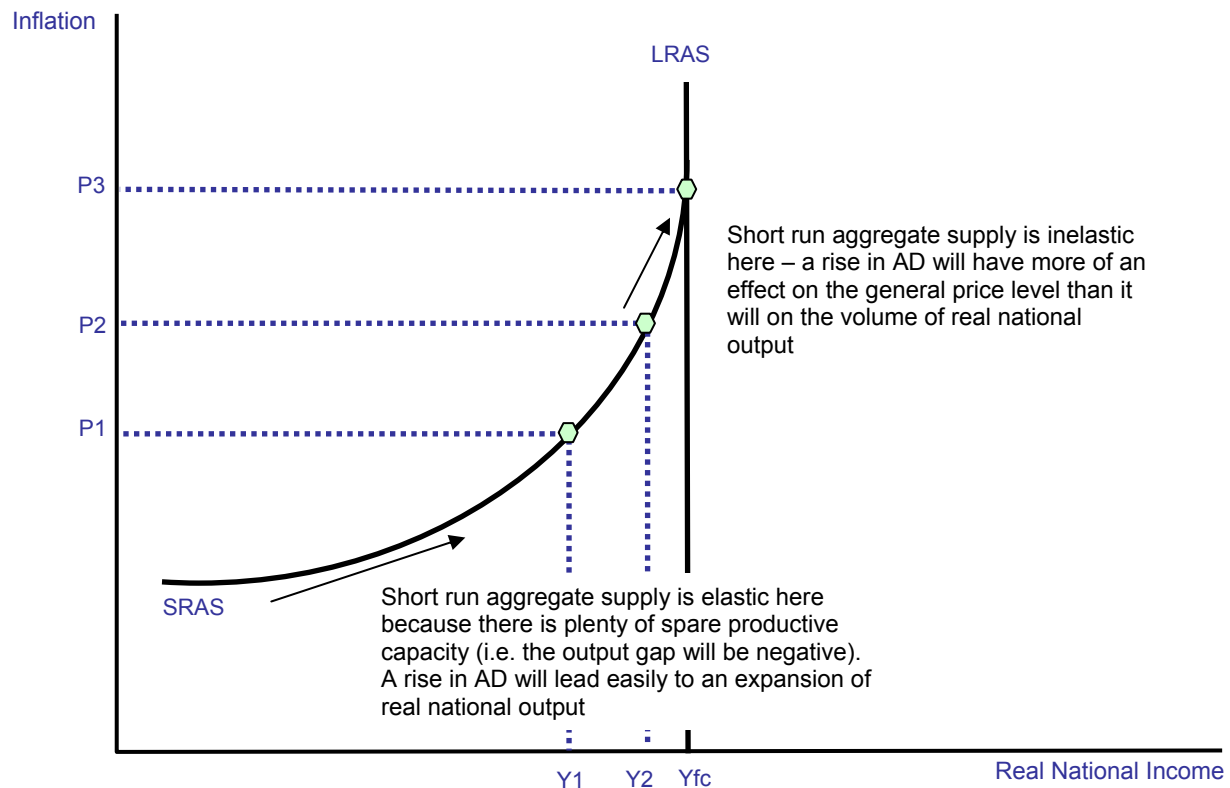


Revision: Supply-Side Policies and Supply-side Performance of the UK

Recap on aggregate supply



Short run supply (SRAS) will shift when there is a change in

- Unit labour costs
- Prices of raw materials, components used in producing goods and services
- Indirect taxes and subsidies
- Effects such as climate factors, disruptions to supply

In the long run, the ability of an economy to produce goods and services to meet demand is based on the **state of production technology** and the **availability and quality of factor inputs**.

A long run production function for a country is often written as follows:

$$Y^*t = f(Lt, Kt, Mt)$$

- Y^* is an aggregate measure of **potential output** in an economy
- t is the **time period** under consideration
- L represents the **quantity and ability of labour input** available to the production process
- K represents the **available capital stock**, i.e. machinery, buildings and infrastructure
- M represents the **availability of natural resources** and materials for production i.e. land

LRAS is determined by the **stock of a country's productive resources** and also by the **productivity of factor inputs** (labour, land and capital). Changes in the state of technology also affect the potential level of real national output.

Supply-side policies relate mainly to LRAS and are designed to:

1. Improve **incentives** for people to search for and find work
2. Increase the occupational and geographical **mobility of labour** to reduce structural unemployment
3. Increase the **productivity** of labour and capital inputs to raise the trend growth rate
4. Increase **capital investment** and **research and development** spending by firms
5. Stimulate inflows of **overseas investment** to boost real GDP and employment
6. Increase **business efficiency** by promoting more **competition** within markets
7. Stimulate a faster pace of **invention and innovation** throughout the economy – the drive growth and improve dynamic efficiency
8. Provide a platform for **sustained non-inflationary growth** – thereby helping to avoid some of the **“trade-offs”** between macroeconomic objectives (e.g. the trade off between unemployment and inflation)

Key points – these supply-side policies are designed to

1. Make markets work better – correct for some instances of **market failure**
2. Increase the **trend growth rate** / growth of **potential GDP**
3. Improve a country’s international **competitiveness** / balance of trade in goods and services
4. Generate higher average **living standards**
5. Reduce unemployment without causing accelerating inflation

Different approaches to the supply side

Neo-Liberal, Free-market Approach

Cut government spending and taxes
Laws to control trade union powers
Keep government intervention to a minimum
Tough competition laws and laws to protect intellectual property

Interventionist Approach

State has key role in investing in public services
Tax incentives and welfare reforms
Regional policy to boost under-performing areas
Perhaps some case for controlling trade to allow domestic industries to expand

Examples of supply-side policies

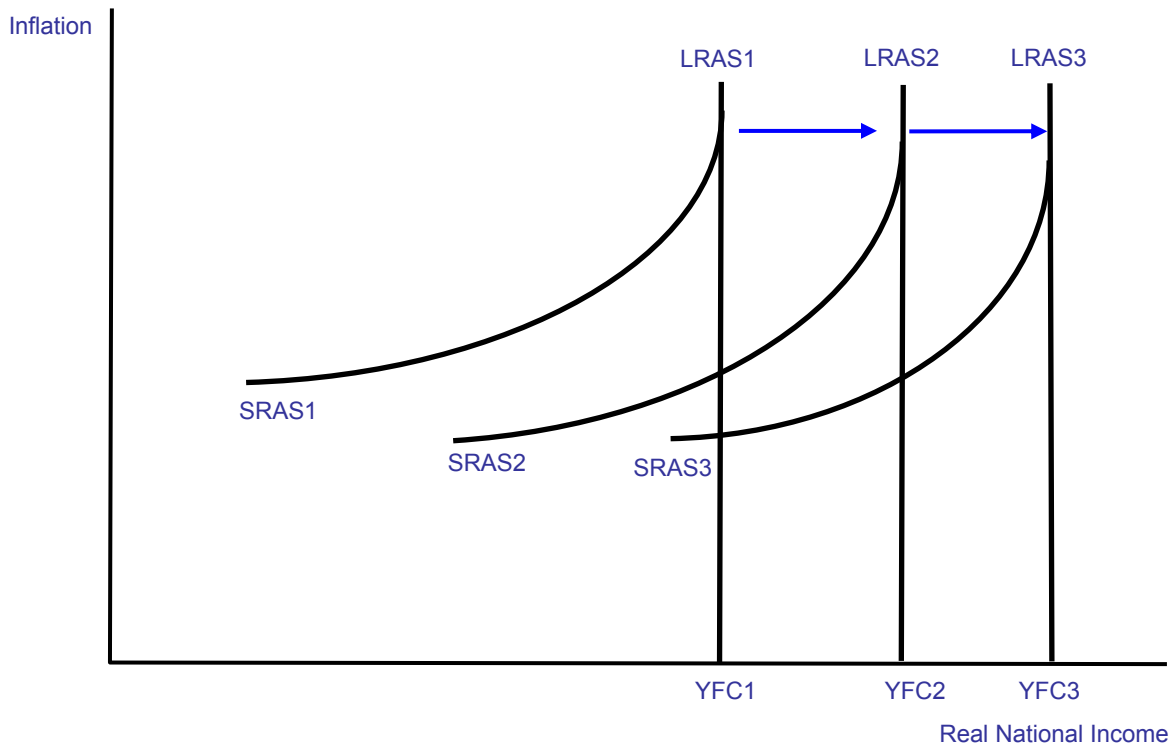
1. Privatisation of state-owned enterprises
2. Opening up markets to new competition (deregulation or liberalisation of markets)
3. Tax incentives (tax credits) for research and development
4. Policies towards inward migration of labour (e.g. measures to attract skilled workers)
5. Reductions in corporation tax and changes to income tax
6. Infrastructure investment (this has demand and supply-side effects!)
7. Policies towards trade and globalisation – generally pro trade and deeper links with other countries
8. Policies on education and training – measures to increase investment in human capital

Remember that fiscal policy can have important supply-side effects

Key evaluation point:

Monetary, fiscal and specific supply-side policies do not work in isolation! A successful combination of all three policies is required to achieve sustainable non-inflationary economic growth!

The effects of a rise in the long run aggregate supply curve on real GDP and inflation



Evaluation: How strong is the supply-side of the UK economy?

Ten positive achievements for the UK supply-side

1. Sustained **economic growth** – despite the many demand and supply-side shocks in the global economy over the last ten years – less economic volatility
2. Sustained fall in **unemployment** without major rise in inflation – suggesting a decline in the NAIRU (non accelerating inflation rate of unemployment)
3. UK has continued to be a favoured venue for **foreign direct investment** – indicative of a strong supply-side
4. Improved **living standards** relative to other EU countries
5. Strong performance in **hi-tech manufacturing** and many **financial services**
6. Rising trade surplus in **creative products** – the world's biggest exporter
7. Evidence of an increase in the UK **trend growth** from around 2% pa to 2.75% pa
8. Better **productivity growth** than many other advanced EU countries
9. More **competition** in many markets – markets have become more contestable – helped by a tougher competition policy regime especially on cartels / price rigging

10. Renewed **entrepreneurial culture** in the UK – rising number of business start-ups

Weaknesses on the UK supply-side

1. Record **trade deficit** – sign of deeper weakness in the economy
2. We still lag behind on **research & development** – falling share of world patents
3. Still huge **skills gaps** to address – high levels of functional illiteracy in the UK – which impacts on productivity and reduces employment opportunities
4. Businesses complaining of effects of increasing burden of **red tape / business regulations** and **rising tax burden**
5. **Capital investment** remains lower (as a share of GDP) than some of our major rivals and there are clear weaknesses in our **infrastructure** especially in transport
6. Long term decline of manufacturing industry - **deindustrialisation**

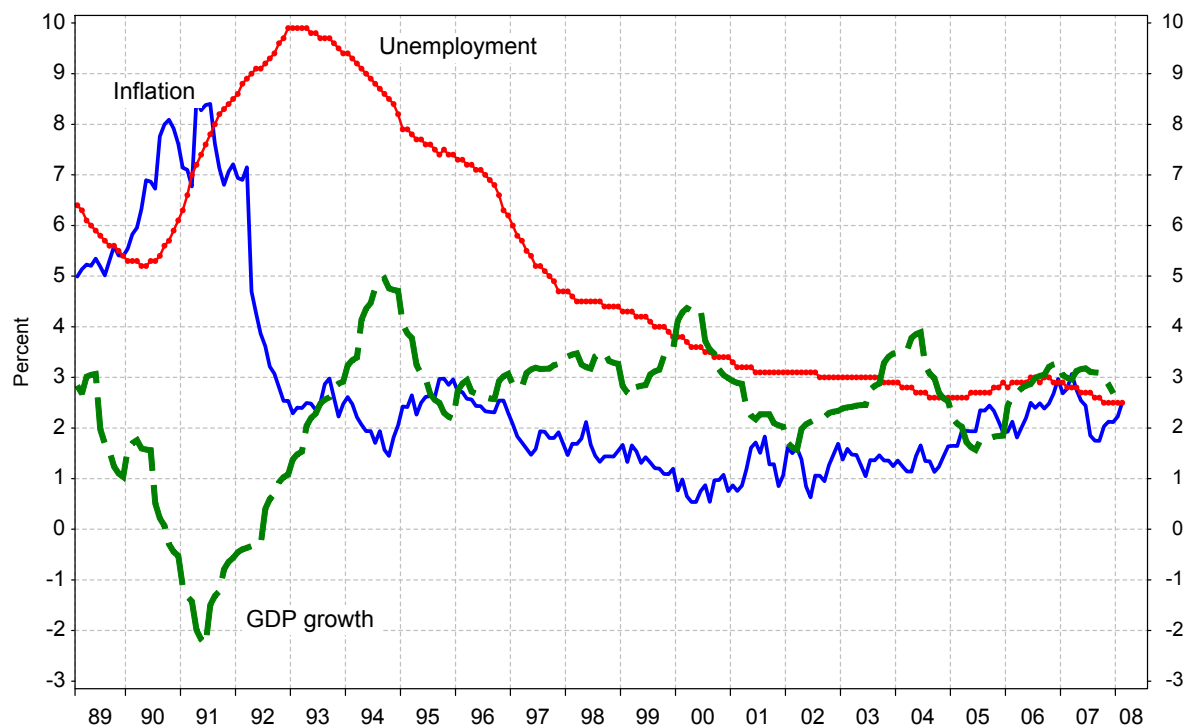
Key concepts to understand for revision

Short run aggregate supply
Long run aggregate supply
Incentives for people and businesses
Productivity
Productive potential
Capital Investment

Research and development
Product and Process Innovation
Skills / Human Capital
Competitive markets / market deregulation
Long run economic growth
Non-inflationary growth

Key Macroeconomic Objectives

Inflation, jobs and growth



Source: Reuters EcoWin

Test your understanding

AS Macro Quiz: <http://vle.tutor2u.net/mod/quiz/view.php?id=1482>

AS Macro Quiz: <http://vle.tutor2u.net/mod/quiz/view.php?id=2131>