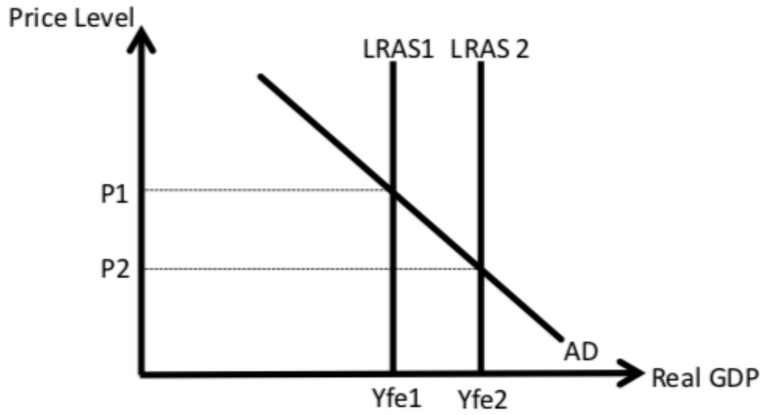
Market Based Supply Side Policies

> **Market Based Supply Side Policies – Policies reducing the role of government that aim to shift LRAS to the right by increasing the economy's productive potential**

Market Based Supply Side Policies – Tax Reform (How they shift LRAS)



1) **Reducing the marginal rate of income tax**. Reducing income taxes increases the incentive to work harder as less income will be taxed away when earned increasing the productivity of labour. Furthermore lower income taxes provide an incentive for those of a working age currently inactive in society to start working and take available jobs, entering the labour force. These factors increase both the quantity and the quality of the labour force, increasing LRAS from LRAS1 to LRAS2.

2) **Reducing corporation tax.** Reducing corporation tax increases the incentive for firms to invest. Firms have a greater level of retained profit to fund investment, which involves spending on new capital, upgrading machinery, building a new factory, improving technology, engaging in research and development and spending on innovation. This investment improves both the quantity and the quality of the capital stock in the economy whilst also improving the productive efficiency of the economy, increasing LRAS from LRAS1 to LRAS2.

Market Based Supply Side Policies – Labour Market Reforms (How they shift LRAS)

3) **Reducing the power of trade unions**. Reducing trade union power reduces the costs of production for firms. This is because trade unions bargain for higher wages, longer worker breaks, longer worker holidays, longer maternity/paternity leave, all of which raise the costs of production for firms. By limiting such action, efficiency in the labour market improves. This improves the productive efficiency in the economy, increasing LRAS from LRAS1 to LRAS2.

4) **Reducing/abolishing minimum wages**. This reduces the costs of production for firms in industries such as retail, leisure, hospitality, recreation, supermarkets and domestic services. By limiting such regulation, efficiency in the labour market improves, increasing the productive efficiency of the economy, increasing LRAS from LRAS1 to LRAS2.

5) **Reducing unemployment benefits in an economy**. This increases the incentive for the inactive to find work and reduce their dependency on welfare, entering the labour force. This increases the quantity of labour in the economy, increasing LRAS from LRAS1 to LRAS2.

Market Based Supply Side Policies – Competition Policies (How they shift LRAS)

6) **Privatisation.** Privatisation of industries creates a profit motive in the industry. More firms enter the market to make profit, increasing competition. Competition and the profit maximisation objective incentivises maximum efficiency where firms aim to lower their costs of production as much as possible to charge lower prices than rivals. This increases the productive efficiency of the economy, increasing LRAS from LRAS1 to LRAS2.

7) **Deregulation.** Deregulation involves reducing laws and government imposed standards in the economy e.g. environmental laws, health and safety laws, product safety laws, maternity/paternity laws, laws regarding working conditions and planning regulations. This significantly reduces the costs of production for firms. At the same time the legal barriers to entry into a market are reduced increasing competition, incentivising maximum efficiency as firms look to remain competitive. Both factors improve the productive efficiency of the economy, increasing LRAS from LRAS1 to LRAS2.

8) **Trade Liberalisation.** Trade liberalisation involves the removal of trade barriers such as tariffs and quotas, freeing up trade promoting global competition. The fierce and intense nature of global competition forces producers to do whatever they can to compete. Competition and the profit maximisation objective incentivises maximum efficiency where firms aim to lower their costs of production as much as possible to charge lower prices than rivals. This increases the productive efficiency of the economy, increasing LRAS from LRAS1 to LRAS2.

As LRAS increases due to successful supply-side policies…

1) Growth. Potential and actual growth increases from YFE1 to YFE2. This is because with greater demand in the economy, firms respond by increasing output. This increase in output is an increase in real GDP, which is an increase in economic growth.

2) Unemployment. Unemployment decreases. This is because labour is a derived demand, derived from the demand for goods and services. As the demand for goods and services is high, firms will need more workers to produce extra output, thus reducing unemployment.

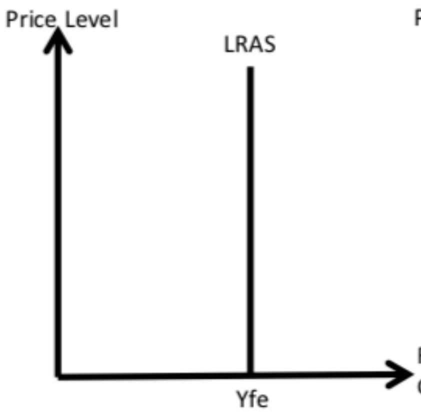
3) Inflation. Cost push inflation decreases from P1 to P2. This is because there is less pressure on factors of production reducing the rate of their price increases thus reducing the rate at which the prices of goods and services rise.

4) Trade Position. The trade position in the economy is likely to improve. This is because with a lower inflation rate, exports are more competitive, increasing the demand for them and the revenue brought in by them.

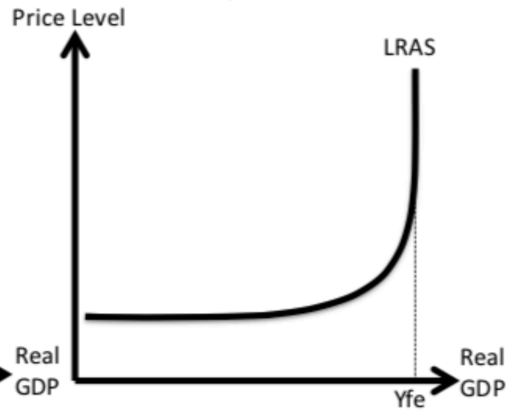
1.3 Classical and Keynesian Long Run Aggregate Supply (LRAS)

- **Classical LRAS – The maximum level of output an economy can produce using all factors of production at sustainable levels; The productive potential of the economy**
- **Keynesian LRAS - The total amount of goods and services that producers are willing and able to produce at a given price level in a given time period**

Classical LRAS



Keynesian LRAS



1) The classical LRAS curve is fixed and therefore vertical at the full employment level of output (Yfe). This is because classical economists believe that there is only one long run equilibrium, Yfe, which the economy will always return to in the long run.

2) The Keynesian aggregate supply curve is shaped due to the level of spare capacity available in the economy indicating that the economy can be in the long run at any level of output (Real GDP) due to the inflexibility of wages downwards. When there is a large level of spare capacity Keynesians believe that the output can increase without putting excess pressure on existing factors of production given the large amount of unemployed factors of production available in the economy. Therefore Real GDP can increase without any demand pull inflationary pressure, hence why the curve is horizontal at low levels of Real GDP. It is only when the economy approaches full capacity, Yfe, that for Real GDP to increase, pressure is put on existing factors of production increasing the price of them and thus costs of production for businesses feeding through to higher prices, increasing the inflation rate. There comes a point when no spare capacity exists and thus Real GDP cannot increase without large increases in inflationary pressure, unsustainable production. This is where Keynesians agree with Classical thought and the curve becomes vertical.

LRAS Determinants (Quantity/Quality of Factors of Production & Productive Efficiency)

1) Labour Productivity. Any improvements in education and adult training will improve human capital, skills and therefore labour productivity. This is an improvement in the quality of labour thus shifting LRAS to the right from LRAS1 to LRAS2.

2) Investment. For example firms spending on new capital, upgrading machinery, building a new factory, improving technology, engaging in research and development and/or spending on innovation. This investment improves both the quantity and the quality of the capital stock in the economy whilst also improving the productive efficiency of the economy, increasing LRAS from LRAS1 to LRAS2.

3) Infrastructure Improvements i) E.g. on transport infrastructure includes new roads, airports, ports, runways, train lines, rail electrification. This reduces the costs of production for firms as transporting goods and services around the country and internationally becomes quicker, easier and more efficient. This increases the productive efficiency of the economy increasing LRAS from LRAS1 to LRAS2.

ii) Infrastructure improvements increase the quantity and quality of the capital stock of the economy for example by building new schools, hospitals, railway lines, roads, electricity infrastructure etc. This will increase LRAS and thus boost the productive potential of the economy from LRAS1 to LRAS2.

4) Competition. Policies that increase competition such as privatisation, deregulation and trade liberalisation will force firms to be as efficient as possible to keep costs and prices as low as possible. This competitive drive will increase productive efficiency and increase LRAS from LRAS1 to LRAS2.

5) Immigration. An increase in the number of immigrants of a working age will increase the size of the labour force in a country thus increasing the quantity and perhaps the quality of labour shifting LRAS to the right from LRAS1 to LRAS2.

6) The institutional structure of the economy such as banks and other financial intermediaries that bring together savers and borrowers perform a crucial role of accepting deposits and converting them into loans for entrepreneurs and business to fund investment (facilitating the increase in the quantity and quality of the capital stock). A strong institutional structure in an economy will ensure persistent increases in LRAS from LRAS1 to LRAS2.