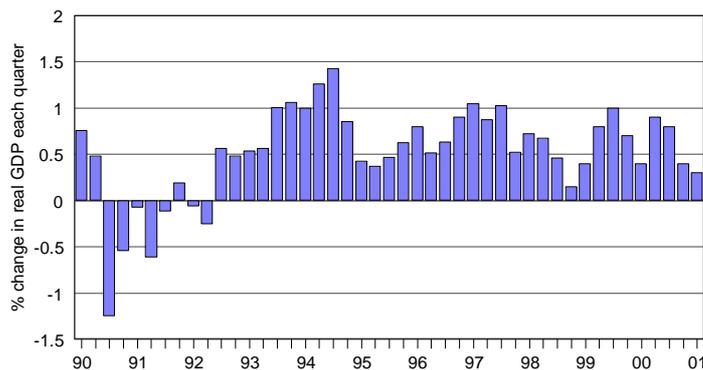
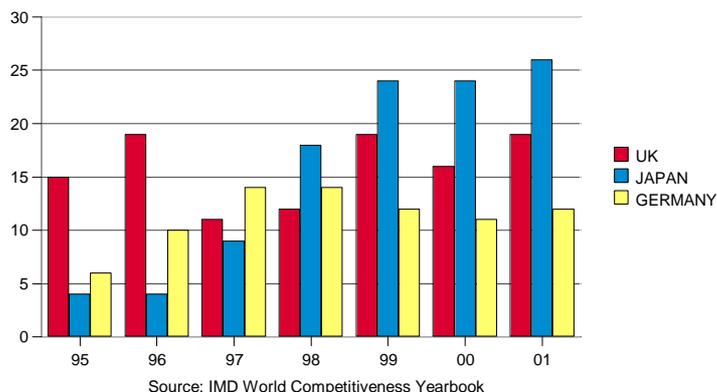


Revision Special on The UK Supply-Side

UK ECONOMY IS SLOWING DOWN



INTERNATIONAL COMPETITIVENESS RANKINGS



Economists spend a lot of time focusing on aggregate demand for goods and services. But the **supply-side of the economy** is equally vital if a country is to enjoy long run economic growth and rising prosperity.

In this revision special we focus on some of the key supply-side policies introduced in recent years and consider whether there has been a significant improvement in the supply-performance of the economy.

Nine years of sustained economic growth suggests something is going right for the economy—although the macroeconomic conditions for growth have been as favourable as at any time in many years. Falling unemployment and rising business investment as a share of GDP are also favourable trends for long run prosperity.

However the economy is now entering a period of fragility—the global economy is slowing down—can the British economy weather the storm clouds? The latest IMD World Competitiveness Rankings sees the UK slipping to 19th place.

The true test of the supply-side of the economy is now it responds to an economic downturn

INDICATORS OF SUPPLY SIDE ECONOMIC PERFORMANCE

		1998	1999	2000
Real National Output (GDP)	% annual change	2.2	2.3	3.0
Gross Fixed Capital Spending	% annual change	10.1	5.4	2.3
Exports of Goods & Services	% annual change	2.6	4.0	8.4
Whole Economy Productivity	% annual change	1.1	1.7	2.5
Employment Rate	% of pop aged 16+	59.0	59.5	59.9

RECOMMENDED WEB SITES

Federation of Small Businesses
www.fsb.org.uk

Supply-Side University
www.polyconomics.com/univ.htm

The Standard (Europe)
www.thestandardeurope.com

Tutor2u Economics www.tutor2u.net
Hundreds of pages of revision notes, links and a Discussion Forum.

Supply and Product Markets

Supply-side economic policies are mainly micro-economic measures designed to

1. Improve incentives for people to actively search for and accept work - thereby boosting the active labour supply
2. Increase the trends rate of growth of productivity of labour
3. Increase the occupational and geographical mobility of labour to promote labour flexibility and lower unemployment
4. Increase the level of capital investment and research and development spending by firms
5. Increase business efficiency by promoting greater competition within markets

We make a distinction between supply-side policies affecting **product markets** (where goods and services are bought and sold) and those that are directed to improving the working of **labour markets** (where factor resources are bought and sold)

Policies in the product market are designed to increase **competition**, and so **efficiency**. If the **productivity** of an industry improves, then it will be able to produce more with a given amount of resources, shifting the LRAS curve to the right. All of the following policies are, in some way or another, trying to increase the level of competition in product markets.

Supply-side policies and product markets

Privatisation.

Privatisation was the major supply side policy on the product market side of the 1980s and 1990s. It became one of the hallmarks of economic policy under Mrs Thatcher and John Major. The privatisation of various large former state-run industries (telecommunications, electricity, water, steel, gas, rail etc.) was designed to break up the state monopolies to create more competition. Many of these privatisations simply turned public sector monopolies into private sector monopolies, but there have been efforts to introduce competition into these industries thereby stimulating gains in static and dynamic efficiency. The government also created **utility regulators** who have imposed strict price controls and who are now overseeing the move towards competitive markets in areas such as gas and electricity supply and telecommunications.

Deregulation.

This is closely linked to privatisation. De-regulation means the **opening up of markets** to greater competition. The aim of this is to **increase market supply** (driving prices down) and **widen the choice** available to consumers. The discipline of increased competition should also lead to greater **cost efficiency** from producers – who are keen to hold onto their existing market share. Good examples of deregulation to use in exam answers include: Urban bus transport, parcel delivery services, mortgage lending, telecommunications, gas and electricity supply.

Commitment to free trade

The UK government has signed up to trade agreements brokered by the **World Trade Organization**. Trade creates competition and should be a catalyst for improvements in cost and lower prices for consumers. The United Kingdom is also a full-paid up member of the **European Single Market** – promoting free trade and free movement of goods, services, labour and capital throughout the fifteen member nations of the European Union.

Measures to encourage small business start-ups

Small businesses are the lifeblood of the economy. According to the Department for Trade and Industry, there were an estimated 3.7 million active businesses in the UK at the start of 1999. The business stock is 1.3 million higher than in 1980 (the first year for which comparable figures are available). Most of the growth in the business population between 1998 and 1999 has been in the 1-4 employee category.

In 1999, 63% of all businesses involved the self-employed and a further 26% employed between 1-4 additional employees. Over 5.5 million people are employed in businesses with fewer than five people. Nearly three-quarters of the increase in employment between 1995 and 1999 came from small and medium-sized firms, according to research published by the Small Business Service. A useful site to visit on this is the **Federation of Small Businesses** (see page 1 of this briefing)

Supply and the Labour Market

Supply Side Policies for the Labour Market

These policies are designed to improve the **quality** and **quantity of the supply of labour**. An expansion of the labour supply increases the productive potential of an economy. Increased quality will improve the productivity of labour. As with product market policies, successful labour market supply side policies will shift the Long Run Aggregate Supply curve to the right

Trade Union Reforms

Many legal protections enjoyed by the trade unions have been taken away – including restrictions on the right to take industrial action and enter into restrictive practices agreements with employers. The result has been an increase in the flexibility of the labour market, a decrease in strike action in virtually every industry and a significant improvement in industrial relations.

Increased Spending on Education and Training

Economists disagree about the scale of the social returns from higher spending on education – but few deny that “investment in education” has the potential to raise the stock of skills within the work force and improve employment prospects.

The economic returns from extra education spending can vary according to the stage of economic development that a country has achieved. In 1999, research from the London School of Economics found that putting more money into education has a direct impact on improving economic performance. The report from the university's Centre for Economic Performance suggested that developing countries which increase education spending and achieve a higher-qualified workforce can expect “handsome dividends: for workers, firms and the state”

Government spending on education and training improves workers' **human capital**. They become better quality workers. Their productivity improves and so the LRAS curve shifts to the right.

Economies that have invested heavily in education are those that are well set for the future. Most economists agree, with the move away from industries that required manual skills to those that need mental skills, that investment in education, and the retraining of previously manual workers, is absolutely vital. It should also be noted that improved training, especially for those who lose their job in an old industry should improve the occupational mobility of workers in the economy. This should help to reduce the problem of **structural unemployment**.

A well-educated workforce acts as a magnet for **foreign investment** in the economy. The Irish economy is a great example of how supply side reforms designed to increase the qualifications and skills of the labour force, together with favourable tax rates for companies and workers – has encouraged a huge flow of inward investment from overseas (in particular from the United States).

The Chancellor of the Exchequer Gordon Brown announced in his July 2000 Comprehensive Spending Review that the education budget over the next four years would increase by an annual average of 6.6%. This will lead to an increasing share of national income taken up by education spending.

Income Tax and the Incentive to Work

Income tax is paid directly from earned income. Many economists who support supply-side policies believe that lower rates of tax not only provide a short term boost to demand – but they also improve **incentives** for people to work longer hours or take a new job – because they get to keep a higher percentage of the money they earn.

In the 1980s the Conservative government cut income tax rates across the board – but the greatest tax reductions were handed out to higher income groups. The highest marginal rate of tax was reduced from 80% in 1979 to 60% by 1987 and then 40% in 1988. The top rate of tax has remained at this level since then.

The basic rate of tax has come down more gradually from 33% in 1979 to 22% today. Attention has focused in recent years on lower income households. In the mid 1990s, a lower starting rate of tax of 10% was introduced and the band of income on which this is paid has been widened in recent Budgets. Cutting tax rates for lower paid workers may help to reduce the extent of the **unemployment trap** – where people calculate that they may be no better off from working than if they stay outside the employed labour force.

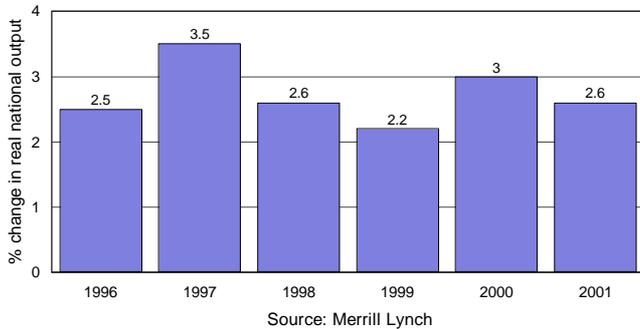
Do lower taxes really help to increase the active labour supply in the economy?

It seems obvious that lower taxes should boost the incentive to work because tax cuts increase the reward from a job. But some people may choose to work the same number of hours and simply take a rise in their post-tax income! Millions of other workers have little choice over the hours that they work. Lower taxes and benefit reforms are seen to go hand in hand in a bid to sharpen the incentives to take paid work.

Indicators of Supply-Side Performance

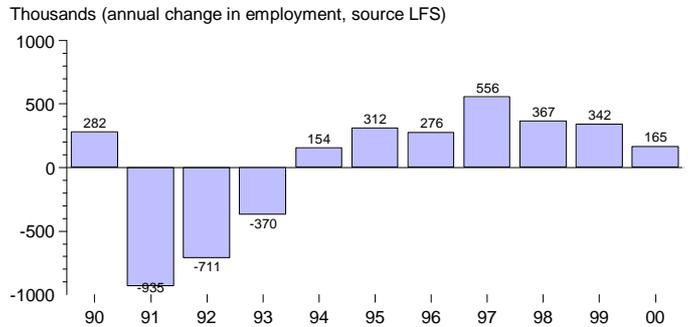
Nine years of sustained economic growth

THE UK GROWTH STORY CONTINUES INTO 2001



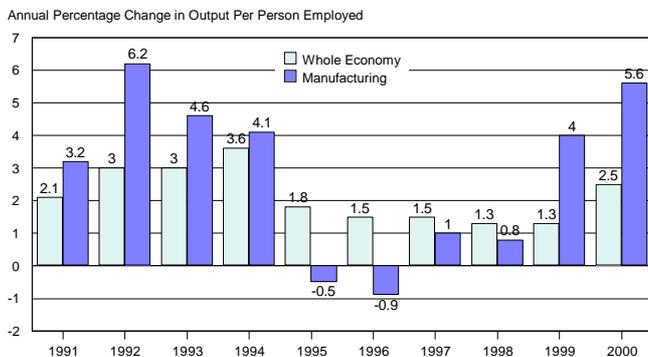
Leads to a large rise in paid employment levels

ANNUAL EMPLOYMENT CHANGE IN THE BRITISH ECONOMY



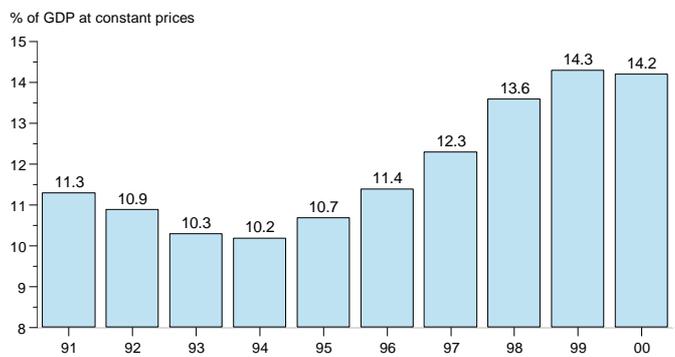
Productivity is higher

WHOLE ECONOMY PRODUCTIVITY GROWTH



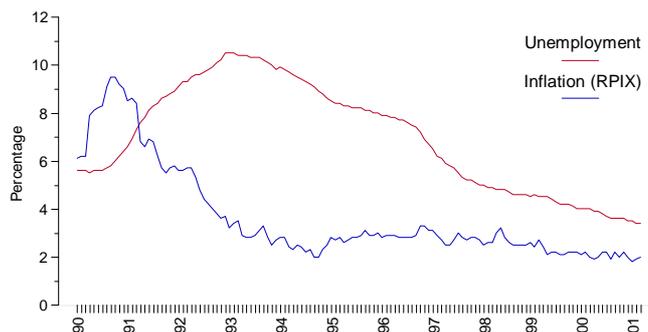
Perhaps boosted by higher investment spending..

BUSINESS SECTOR INVESTMENT



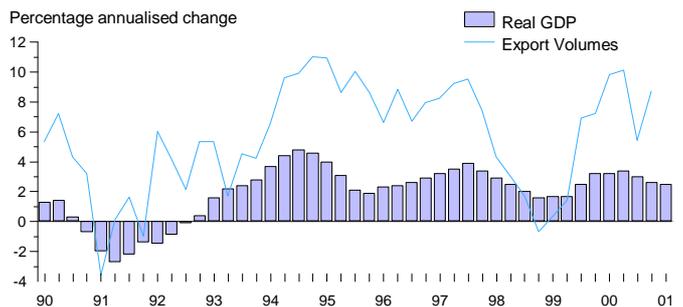
The Inflation-Unemployment trade off has improved

A TRADE-OFF BETWEEN UNEMPLOYMENT AND INFLATION?



And exports are defying the strong pound

EXPORTS AND NATIONAL OUTPUT



The performance of the UK economy over the last eight years provides strong evidence that the supply-side of the economy has undergone an improvements. Investment as a share of GDP has risen and there are signs that the rate of growth of productivity is beginning to benefit from this capital deepening. The employed labour force is over two million higher than at the start of 1993 and unemployment is now at its lowest level for over twenty five years. This has been accompanied by a continued low and stable rates of inflation and a reduction in structural and regional mismatches in the labour market.

The NAIRU has fallen—perhaps close to the current rate of unemployment shown by the labour force survey (5.2%). Despite the strength of the pound, exports volumes have held up well. Indeed exports of goods and services expanded in excess of 8% last year—a reflection of the efforts of UK exporters to control costs and cut profit margins. The UK economy is well placed to absorb some of the effects of a wider global economic slowdown in 2001.