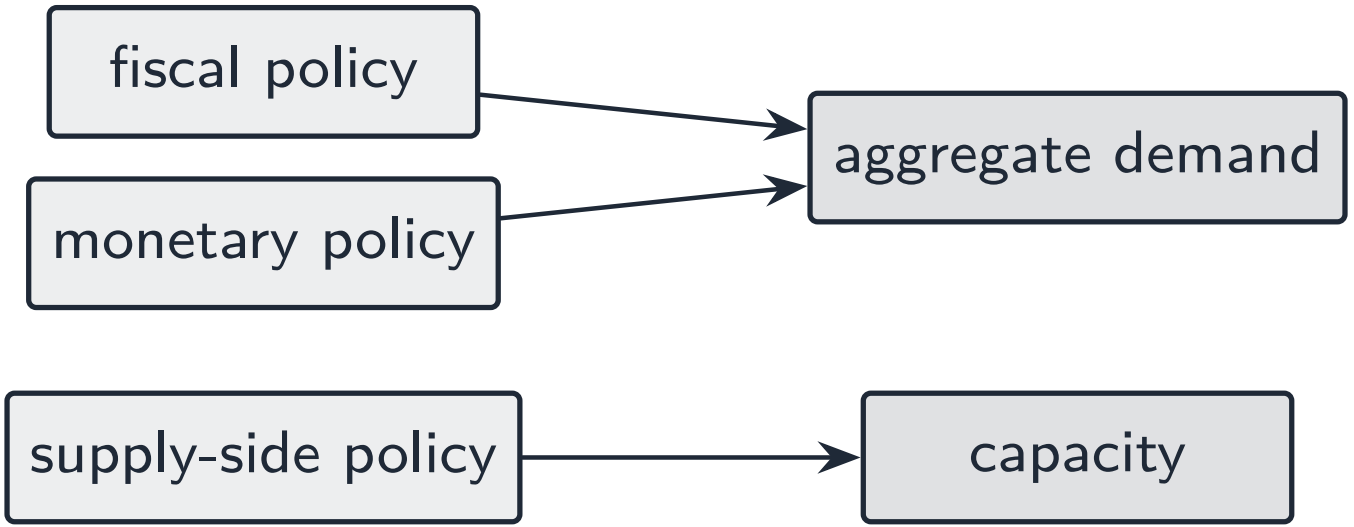
Exercise walk-through

5.8
Supply-side policies

International Baccalaureate · IB Diploma · Economics · HL

Figure: Macroeconomic activity, objectives and policy

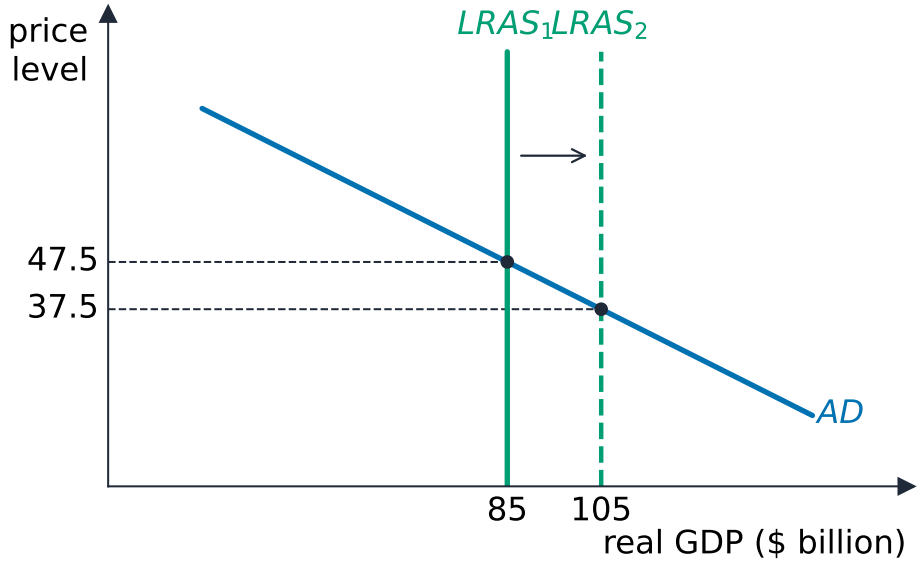


- Fiscal and **monetary policy** act on demand; supply-side on capacity
- Match each part of the diagram to the text.

Supply-side policies

- **Supply-side policies** aim to raise the economy's productive capacity, shifting LRAS to the right.
- **Worked example.** LRAS shifts from 85 to 105 along AD $P = 90 - Y/2$.
- The price level falls from $90 - 85/2 = 47.5$ to $90 - 105/2 = 37.5$ while **real GDP** rises by 20.
- Unlike demand-side policy, this gives growth without **inflation**.

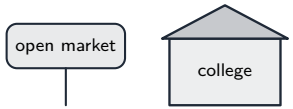
Figure: Supply-side policies



- Supply-side policy raises output and lowers the price level
- Match each part of the diagram to the text.

Exercises 2.1·2.2

2.1 Distinguish between a market-based and an interventionist supply-side policy, with an example of each. [2]

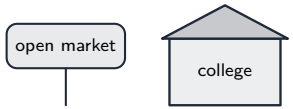


2.2 State **two** ways in which spending on infrastructure can increase potential output. [2]



Exercises 2.1·2.2

2.1 Distinguish between a market-based and an interventionist supply-side policy, with an example of each. [2]



2.1

market-based: increases competition or incentives in markets, with little direct government spending, e.g. deregulation, lower corporate tax; interventionist: the government directly invests to improve supply, e.g. spending on education, infrastructure, R&D

2.2 State **two** ways in which spending on infrastructure can increase potential output. [2]



2.2

any two: faster, cheaper transport lowers firms' costs; better links make markets larger and attract investment; reliable power and internet raise productivity

Exercise 2.3

2.3 Using an AD/AS diagram, explain how investment in education and training can reduce unemployment without causing inflation. [4]



[[drawlines:4]]

Exercise 2.3

2.3 Using an AD/AS diagram, explain how investment in education and training can reduce unemployment without causing inflation. [4]



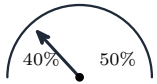
[[drawlines:4]]

2.3

training gives workers the skills firms need, reducing structural unemployment; the quantity and quality of labour rises, so LRAS shifts right; real GDP rises while the price level stays the same or falls; correctly labelled diagram with $\text{LRAS}_1 \rightarrow \text{LRAS}_2$

Exercises 2.4·2.5

2.4 A government cuts the top rate of income tax from 50% to 40%. Explain **two** reasons why this may not increase work effort much. [3]

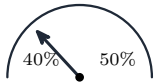


2.5 Explain how privatization might raise efficiency in an industry, and **one** risk. [3]



Exercises 2.4·2.5

2.4 A government cuts the top rate of income tax from 50% to 40%. Explain **two** reasons why this may not increase work effort much. [3]



2.4

higher after-tax pay means workers can earn the same income with fewer hours (income effect), which may offset the incentive to work more (substitution effect); many workers cannot easily change their hours; high earners may already work long hours, and pay may not be the main motive

2.5 Explain how privatization might raise efficiency in an industry, and **one** risk. [3]



2.5

private owners seek profit, so they have an incentive to cut costs and waste; they may face more competition and invest in new technology; risk: a private monopoly may raise prices or cut unprofitable services

Exercise 3.1 (a)

3.1 A country has high structural unemployment and low productivity growth.

(a) Define **supply-side policies**. [2]

Exercise 3.1 (a)

3.1 A country has high structural unemployment and low productivity growth.

(a) Define **supply-side policies**. [2]

(a) government policies that aim to increase the productive capacity (potential output) of the economy; by improving the quantity, quality or efficiency of factors of production / shifting LRAS right

Exercise 3.1 (b)

3.1 A country has high structural unemployment and low productivity growth.

(b) Evaluate the use of interventionist supply-side policies to solve these problems. [6]





Exercise 3.1 (b)

3.1 A country has high structural unemployment and low productivity growth.

(b) Evaluate the use of interventionist supply-side policies to solve these problems. [6]

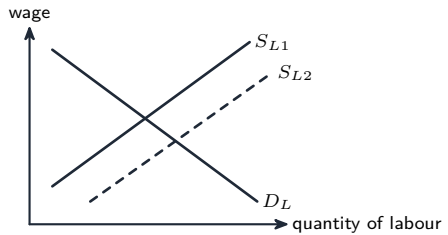


(b) training and education match skills to jobs, reducing structural unemployment; R&D support and infrastructure raise productivity; spending also raises AD in the short run; but there are long time lags before the benefits appear; high cost: opportunity cost or more government debt; the government may pick the wrong industries or skills; judgement: suited to structural problems, but needs time and careful design

Exercise 3.2

3.2 A government plans to reduce unemployment benefits and the power of trade unions to make the labour market more flexible.

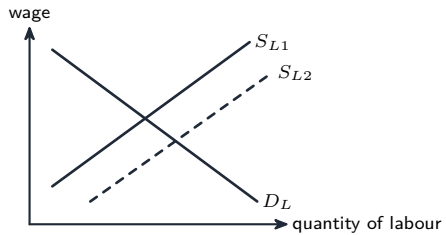
Evaluate these market-based supply-side policies. [8]



Exercise 3.2

3.2 A government plans to reduce unemployment benefits and the power of trade unions to make the labour market more flexible.

Evaluate these market-based supply-side policies. [8]



3.2

award up to [8]: lower benefits increase the incentive to search for and accept work; weaker unions mean wages adjust more easily, so firms may hire more; lower labour costs raise competitiveness and attract investment: LRAS shifts right; low cost to the government compared with interventionist policies; but they increase inequality and in-work poverty; less job security may lower worker morale and consumer spending; if unemployment is mainly cyclical or structural (skills), these policies do little; judgement: may raise flexibility but at an equity cost; best combined with training