

Supply-side policies can have an effect on the demand-side of the key sectors of an economy.

(a) Explain how supply-side policies can have significant effect on the circular flow of income. [10]

(b) Discuss why the above impact might differ for different economies. [15]

Part (a)

The circular flow of income is a representation of how money is circulated in an economy as income and expenditure and it involves all 4 sectors of the economy, namely, households, firms, government and the external sector. It illustrates how all expenditure on the final output of a nation, which is equal to the money value of that output, ends up as someone's income.

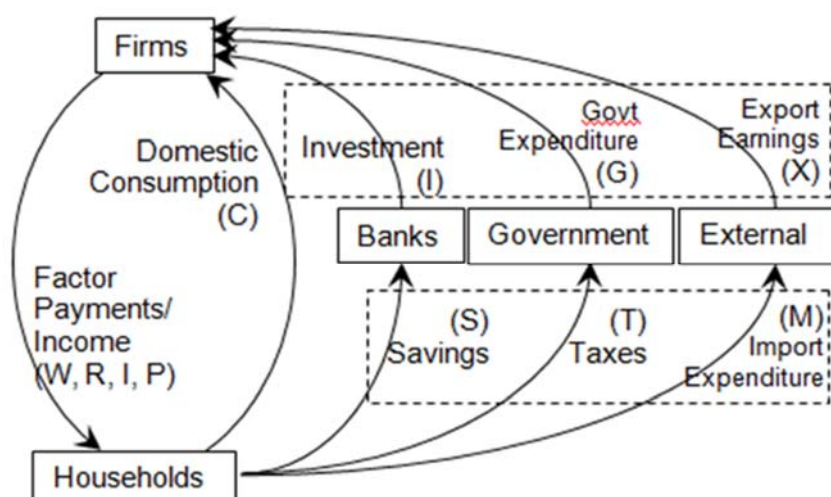


Figure 1: Circular flow of income

With reference to the figure 1, a portion of the income to the households, which is made up of wages, rent, interest and profits, is paid to the firms as consumption. The remaining income leaks out of the circular flow of income and expenditure and end up with financial intermediaries, the government and the foreign sector in the form of savings, taxes and import expenditure respectively. These leakages are also known as withdrawals.

On the other hand, besides receiving payments from the households for the goods and services they produced, firms also receive payments from the government, the foreign sector and other firms in the form of government expenditure, export earnings and investment expenditure respectively. These expenditures, other than that by the households, are known as injections.

When total injections are equal to total withdrawals, the national income is said to be in equilibrium.

Supply-side policies refer to policies that aim to increase the aggregate supply of an economy by increasing the quantity or quality of the factors of production, namely land, labour, capital and entrepreneurship.

Policies that incentivise firms to send their workers for training and policies that incentivise workers to upgrade their skills through attending courses, e.g. training grants such as the SkillsFuture Scheme and course subsidies such as the Workfare Training Support Scheme aim to increase the productivity of the labour force, thus increasing the productive capacity of the economy. These policies also have the effect of increasing government expenditure, which is an injection into the circular flow of income. In addition to that, a more productive workforce ensures sustained economic growth, which has the effect of increasing investor confidence in the economy, thus leading to an increase in investment, which is also an injection into the circular flow of income.

In order to encourage investments and consumption, governments can also decrease taxes. A decrease in corporate tax increases the rate of return of investments, thus incentivising firms to increase investments. A fall in personal income tax results in increased disposable income of households. Consequently households are likely to increase consumption of goods and services, including that of imports. As demand conditions are expected to be good, firms are encouraged to invest in expanding production capacity in anticipation of an increase in demand

The increase in injections and fall in withdrawals from the circular flow of income results in injections exceeding withdrawals from the circular flow. When injections increase, there is an equivalent increase in incomes of firms. These firms in turn increase production and pay out factor income to households, who will spend a portion of the income received i.e. induced C while the rest leaks out as savings, taxes and imports. Firms who receive this increase in income will increase their production, paying out factor income to households, who again increase their C. This cycle of income and expenditure will repeat until there is no further increase in induced consumption. This happens when the level of injections into the circular flow of income equals to the withdrawals. The economy reaches a new equilibrium at a higher level of national income.

In conclusion, supply-side policies can have an impact on the circular flow of income as increases the level of injections relative to withdrawals.

Knowledge, Application, Understanding and Analysis		
L3	Developed explanation of how supply-side policies affect the demand side of the various sectors and subsequently causes the national income to increase significantly using the circular flow. (To gain full credit, candidates should show supply-side can have effect on at least 2 sectors of the economy)	8-10
L2	Undeveloped explanation of how of how supply-side policies affect the demand side of the various sectors and subsequently causes the national income to increase significantly using the circular flow.	4-7
L1	Smattering of valid points.	1-3

Part (b)

From part (a), supply-side policies can affect the demand-side or the aggregate demand and hence the national income. The extent of the effect on national income, however, differs from country to country as it depends on several considerations. These include the size of the income multiplier, the means the government has financed her expenditure and the perception of the consumers and investors on the persistency of the tax changes.

Size of multiplier

For countries with a smaller size of the multiplier due to a large mpm and mpt value, the above impact will also differ from countries with a larger size of the multiplier. For e.g., an economy which is heavily reliant on imports will have a large mpm while an economy with high personal and corporate income tax (probably to maintain an extensive welfare system) will have a large mpt. For such economies, given that $k = \frac{1}{mps+mpt+mpm}$, a high mpm and mpt will mean that the size of the multiplier will be small. Given that $\Delta NY = k \Delta AE$, a change in C & I brought about by a fall in tax rates will not lead to a significant change in NY.

Other factors affect C & I

The above impact might also differ for different countries because it depends on how long the tax cuts are expected to last in the different countries. If the cut in corporate tax and personal income tax is expected to last only for a short period of time in a particular economy, investors may be inclined to hold back investment and consumers may be inclined to hold back consumption since the increase in the expected rate of returns and disposable income will not persist once the corporate tax and personal income tax rate will be back to its original level. In this case, the economy may not see a huge increase in investment and consumption. Thus, AD and thus national income may not rise to a huge extent.

Also, consumer sentiments in the different economies also affect the extent of the above impact. During times when the economic outlook is bleak in a particular economy, consumers and investors may not respond to the fall in personal income tax and corporate income tax as desired. With a poor outlook of the economy, consumers tend to be thrifter and reduce their level of consumption. This will in turn persuade investors to hold back projects more as expected demand condition is low. Thus, the rise in consumption and investment is unlikely to be of great significance and NY may not rise significantly.

As there are unpredictable effects on consumption and investment expenditure given a fall in tax rates, the effects of supply side policies on the demand side of the economy will have an uncertain effect on NY. Supply side policies which affect government expenditure directly would instead ensure a more predictable increase in national income.

Ability of the government to increase G

In addition, the extent of the above impact will differ for different economies as it depends whether the government has sufficient reserves to spend on policies that targets the supply side of the economy. For instance, a government with insufficient reserves will have to borrow money to fund its policies. This will increase the demand for money and cause interest rate to increase. As a result, the cost of borrowing increases and thus, reduces private investment. At the same time, there will be an increase in the opportunity cost of spending, which causes private consumption to fall. As such, the increase in government spending comes at the expense of a fall in private investment and consumption i.e. private investment is 'crowded out'. If the fall in investment completely offsets the rise in government expenditure, AD will not rise at all and there may not be an increase in NY.

Conclusion

Although the impact of supply side policies on the demand side of the economy is uncertain, it should not deter a government from pursuing supply side policies as the primary objective of these policies is to increase the productive capacity of the economy in order to achieve potential growth. This is essential as an increase in AD coupled with potential growth will bring about sustainable/ non-inflationary growth for the economy.

Knowledge, Application, Understanding and Analysis		
L3	Developed explanation of at least 3 reasons of why the impact on national income might differ among economies. Reasons must include the multiplier and the crowding out effect.	9-11
L2	Developed explanation of at least 3 reasons of why the impact on national income might differ among economies but reasons included does not have the multiplier or the crowding out effect. Undeveloped explanation of why the impact on national income might differ among economies. Answers included the multiplier or crowding out effect.	5-8
L1	Smattering of valid points.	1-4
E2	For a reasoned conclusion and substantiated evaluative comments	3-4
E1	For an answer with unsubstantiated evaluative comments.	1-2