ECONOMIC RESTRUCTURING AND SUPPLY-SIDE POLICIES: SOME LESSONS FOR MALTA*

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Abstract. Economic restructuring has become central to attaining and maintaining competitive advantage in increasingly competitive and globalised markets. The 1980s saw a shift from policy dominated by Keynesian theory to supply-side economics, which emphasises individual economic decision-making and how government policies impact those decisions. This paper discusses the importance of supply-side policies. It describes the success countries achieved after applying supply-side policies as well as the supply-side record of the Maltese economy. The special constraints faced by small economies are briefly described. It is argued that the use of supply-side policies is even more important for small states than for larger countries. Such policies should be aimed at improving the proper functioning of markets and overcome the additional costs which small countries face because of their inability to reap scale economies and their lack of diversification.

Introduction

Ongoing economic restructuring is the core mechanism that drives economic growth in modern market economies. Economic restructuring has become central to attaining and maintaining competitive advantage in increasingly competitive and globalised markets. As the International Labour Organisation (1997) observes, “The achievement of sustained and lasting improvements in competitiveness will require not only change but a process of continuous change”.

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Economic restructuring is vital for economies to achieve their long-term development aspirations. This is because, although business enterprises are at the forefront of market competition, the performance of companies is strongly influenced by the economic conditions within the national boundaries within which they operate. It is thus essential for a country to restructure and be competitive, just as it is important for firms to maintain an edge against their competitors. Sir John Browne, chairman of British Petroleum is quoted as saying “The simple fact is that business needs sustainable societies in order to protect its own sustainability”.

Despite extensive literature in the field, the concept of restructuring is still poorly defined and the term is not always clearly articulated and understood. Specification requires that it be positioned along three dimensions: one functional, a second temporal, and a third structural. The first one refers to transformations in the mix of goods and services being produced within an economy. This is frequently measured by the relative share of employment across industrial sectors. The second one refers to a broader set of changes in the nature of the economy, not only in its products and the distribution of employment but also in the social relation of production (e.g. extent of unionisation, part-time versus full-time jobs), the means of production (e.g. robotics, handcrafting), and the forces of production (e.g., profit requirements, market demand). The third involves long-term shifts in the composition of demand, production and occupational patterns. The way in which economies respond to these changes depends upon the type of economic policies pursued by policymakers.

**Historical Context**

The concept of “restructuring” came into common usage in the late 1970s. Economic theory and policy at the time was dominated by Keynesian theory, the essence of which is its conclusion that the level of national income and employment depend on the level of aggregate demand and that easily securable credit and expanded budget deficits, by stimulating demand, can increase output and employment. However, after decades of postwar growth in the US accompanied by rising wages and massive job generation, an unexpected deep recession occurred between 1973 and 1975. The demise of the Bretton Woods system for control of exchange
rates and the OPEC oil shocks of 1974 and 1975 struck an economic and symbolic blow to the international economy. Earlier business cycle fluctuations had involved either high unemployment or some inflation, but not both. However during this period inflation was rampant and unemployment rates soared.

In the late 1970s stagflation was the norm. The recession hit the economy with a forceful crash as manufacturing plant after manufacturing plant shut its doors or laid off most of its work force. The impact was felt by all sectors of the economy, and major cities such as New York nearly went bankrupt. It was argued that capitalism was undergoing a structural crisis. This crisis led to a situation in which “it becomes impossible to expand or reproduce the system without a transformation of the basic characteristics of production, distribution and management, and their expression in terms of social organisation” (Castells, 1980).

Friedrich von Hayek, a defender of the free market and of classical liberal policies, claims that Keynes confessed to him that his policy prescriptions would be inherently inflationary, but that when the moment came he would step in and turn public opinion around in six weeks. When Hayek used to tell this story, he always used to add, with an ironic grin, that six weeks later Keynes was dead! (Hatch, 1981).

Thus, although the policy recommendations put forward by Keynes may have been appropriate during the depression years of the 1930s when Keynes developed his theory, by the 1960s and 1970s it was clear to most economists that it was wrong to focus exclusively on demand and to ignore factors that increase the potential supply of output – capital accumulation, technical progress, improvements in the quality of the labour force, freedom from regulatory interference, and increases in personal incentives (Feldstein, 1986).

This realisation brought about the rise of supply-side economics, which brings the economics discipline back to its microeconomic roots. In fact, much of supply-side economics is a return to basic ideas about creating productive capacity and removing government impediments to individual initiative that were central in Adam Smith’s Wealth of Nations and in the writings of the Classical economists of the nineteenth century.
The experience of the 1930s had temporarily made it easy to forget the importance of supply-side factors but by the 1970s they were returning to the mainstream of economics. Many classical economists also concluded that the persistently high level of measured unemployment present at the time did not reflect inadequate demand but was instead due to government policies such as unemployment insurance, welfare restrictions, and the minimum wage.

The Basics of Supply-Side Economics

Supply-side economics takes its cue from Say's Law of Markets that states that goods are ultimately paid for with other goods. Say argued that “the encouragement of mere consumption is of no benefit to commerce; for the difficulty lies in supplying the means, not in stimulating the desire of consumption; and we have seen that production alone furnishes those means. Thus it is the aim of good government to stimulate production, of bad government to encourage consumption.” Thus, supply-side economics emphasises individual economic decision-making and how government policies impact those decisions. In fact, the supply-side view is that the only way to increase the economy’s potential income is to make the economy more competitive and that the role of government is to create an environment in which free enterprise and competition will flourish.

In summary therefore supply-side economics is built on the following tenets:

*Incentives matter.* Individuals naturally respond to incentives. For example, the relative prices, or costs, of consumption versus investment, or risk avoidance versus risk taking, influence the behaviour of individuals, families, and businesses.

*Markets work.* The free, unfettered market provides clear incentives—through price and profit signals—that tend to allocate resources to their most efficient and beneficial uses. Supply-side economics emphasises the importance of production within the context of the free market. In order to be of value, production must meet or create a demand. After all, the end point of the entire economic process is consumption.
Supply-side policy is driven by two policy levers. The first is the fiscal lever—tax, regulatory, and spending policies geared toward establishing a pro-growth economic environment. The second is the monetary lever—monetary policy geared to establish price stability upon which an economy can function and flourish.

The fiscal policy prescriptions that are deeply rooted in supply-side economics concern taxation, the size of government in the economy and free trade.

Taxation

The principal policy weapon for supply-siders is tax rate reduction. The basic argument is that marginal tax rates influence economic decisions. For example, the marginal tax rate helps determine the relative price of work vs leisure, investment vs consumption, risk taking vs risk avoidance, and so on. Classical economists argue that low tax rates are central to an economy’s success as this will increase rewards to suppliers of labour and capital inducing them to work more and supply more savings.

A reduction in personal income tax rates and/or the progression of the rates increases after-tax wages. A change in the after-tax wage alters the work-leisure trade-off, as an increase in after-tax wages raises the price of leisure. As after-tax wage rates rise, labour willingly substitutes more work for leisure. Thus, labour is induced to work harder and longer for higher after-tax wages, increasing the supply of labour and its own productivity. This increased work effort keeps the wage bill component of prices and prices themselves down. When tax rates on wage income are reduced, the supply of labour increases, pre-tax wages fall and employment increases.

A reduction in personal income tax rates and/or the progression of the rates increases after-tax yields on financial assets. A change in after-tax yields alters the consumption-saving trade-off. An increase in after-tax yields raises the price of current consumption. As after-tax yields rise, households willingly substitute more saving (or future consumption) for current consumption. Households are induced to save more at the higher after-tax yields, thus increasing the supply of saving which is available for investment. This increased saving keeps the interest and dividend
components of prices and prices themselves down. When tax rates on interest income are reduced, the supply of saving increases, pre-tax interest rates fall, and investment increases. The increased investment increases the nation's stock of capital, its resource base, and its potential supply of goods and services to the markets.

A reduction in corporate income (profits) tax rates increases the expected rate of profitability on new capital. Lower corporate income (profits) tax rates increase investment demand at each and every interest rate. Businesses add new capital and update facilities, increasing the capacity to produce more output. Coupled with lower interest rates from increased household saving, investment spending on new capital increases. The demand for new capital also increases the demand for labour. Employment rises, while wages are kept low by the increase in labour supply. The increased capacity of businesses will make output expansion possible at little or no extra cost, thus keeping prices from rising. The total effect of such tax reductions will be to increase employment, output, and income. This larger income, taxed at the lower rates, will raise as much, if not more, tax revenue for the government than without the reductions. Thus, tax cuts pay for themselves.

Advocates of supply-side economics contend that a general cut in rates would yield a larger volume of real tax revenue as illustrated in the so-called Laffer Curve. At high tax rates resources will be diverted to tax-exempt and underground activities. At tax rates increase, but remain low, the income effect is dominant. Individuals will work harder to raise their incomes to compensate for the increased tax. At some higher tax rate, however, the additional income earned is taxed at such a high rate that the initiative to work harder and earn more income falls. At that tax rate, the substitution effect would set in and individuals cut back on their supply of productive effort and substitute leisure for work. As a result, the government collects the same tax revenue from two different sets of tax rates. There is thus is an optimum tax rate at which the government maximises its tax revenues. The implication of this hypothesis is that, at high tax rates, the government can actually take in more tax revenue by cutting taxes.

Supply-side recognition that supply comes before demand in the economic order leads to a preference for taxing consumption rather than
production. As is the case with all taxes, taxing consumption too heavily most assuredly cripples an economy. In the end, a low-rate, consumption-based tax makes the most sense from a supply-side economics perspective.

Bureaucratic regulation may simply be another form of taxation—though largely hidden from consumers’ eyes. Regulations, such as those associated with starting up a new business would increase costs of investment and entrepreneurship, and thereby restrain economic growth and job creation. Streamlining, modifying, or eliminating many of these regulations will encourage more business start-ups.

**Limiting the size of Government in the Economy**

The total size of government is another main focus of supply-side economics. Without the disciplines of prices, profits, losses, and private ownership, government is inherently wasteful, and therefore, should be quite limited in its duties. Supply-side policies that reduce the size of the government in the economy and allow production to be restructured by focusing on greater private sector initiative include privatisation, limited government borrowing and a reduction in welfare spending.

Privatisation has enabled many a cash-strapped public sector across the globe to access new capital to invest in essential infrastructure; improve service provision in sectors as diverse as manufacturing and healthcare; promote economic democracy through wider share ownership; and create employment opportunities through liberalising and expanding market opportunities in previously moribund state monopolies. The transfer of resources to the private sector can be carried out through the following processes:

- **Denationalisation.** The transfer of public sector enterprises such as the parastatals (often monopolies) to the private sector.
- **Contracting-out.** Allowing public sector enterprises to buy services from the private sector by putting services out to tender.
- **Deregulation.** The removal of government controls from an industry or sector to allow for a free and efficient marketplace.

Supply-side economists claim that as government borrowing falls, the demand for money falls, reducing interest rates. This frees up money
balances to complement private sector saving. New investment demand increases the demand for money, but this increase in business borrowing can be accomplished without an overall increase in interest rates, because of the reduction in government borrowing and increase in household saving.

Social welfare programmes can discourage work effort, create incentives for people to become needy and encourage work in the underground economy. Thus, a reduction in social welfare programmes, such as reducing unemployment benefits and eliminating the minimum wage, will increase potential output. In fact, it is claimed that the liberal social benefits policies present in Europe are responsible for the high unemployment rates there. In a free market, excess supply of labour leading to unemployment would clear itself through a fall in the wage rate of labour. If wages are prevented from falling by the existence of trade unions or minimum wages, then the labour market will fail to clear and unemployment continues.

Supply side economists also advocate reducing the power of trade unions, abolishing minimum wages, increasing work incentives, and increasing the skills of the labour force to enhance labour productivity and bring about a decrease in structural unemployment.

Free Trade

From a supply-side point of view, eliminating international barriers to trade lowers costs, expands and opens markets and opportunities, enhances incentives for production, boosts competition, improves quality, reduces consumer costs and expands consumer choices. Competition – the driver of economic progress – increases the potentially sustainable growth rate nationally, regionally, and internationally.

Free trade captures the benefits of “comparative advantage.” Quite simply, comparative advantage predicts that economies boost economic prosperity by producing the goods and services they are most efficient at producing, and then trading to acquire other goods and services they need and want. The extent to which a country can take advantage of free trade depends on how flexibly it can adapt to changing circumstances, and therefore upon the supply-side characteristics of the economy.
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The Monetary Lever

In the supply-side view, the only objective of monetary policy should be price stability. In turn, a sound currency and stable prices create an environment where investment and the economy can flourish. Some supply-siders call for a gold price rule, where central banks target a certain gold price range, and vary monetary policy accordingly (e.g., if the price of gold goes above the targeted range, then tighten policy; if the price drifts below the target, then loosen monetary policy). Other supply-siders call for a return to a classical gold standard. Either way, the point is to establish a market-based discipline by which to guide monetary policy.

Criticism of Supply-Side Policies

Although theoretically appealing, supply-side policies encounter a number of criticisms regarding their practical validity because of timing and policy calibration factors, as well as social and political resistance.

The Time Dimension Constraint

Although the Laffer Curve may operate effectively in the long run, its proponents wish to use it for short-run budget balancing and fine-tuning of the economy. However, the immediate effects of a tax cut are to lower government revenue and increase the budget deficit. If government attempts to borrow this lost revenue from the private sector, it will inevitably raise interest rates and crowd-out the additional private investment demand sought by the tax cut. On the other hand, if government decides to print money to finance its revenue loss, it merely shifts the required resources from the private to the public sector through inflation.

The Empirical Constraint

The task of the economic policy maker to find that tax rate that maximises tax revenue along the Laffer curve is very subjective as the curve is an imaginary representation of people’s tastes and preferences regarding work, leisure, saving, and investment, which cannot be measured easily. And even if people's preferences could be known for certain,
they cannot be assumed to remain constant. By the time a tax cut is enacted and implemented, the curve may have shifted considerably. Alternatively, the curve may have more than one revenue maximising point.

Social Effect of Reducing Social Welfare Programmes

The downside to eliminating or drastically altering social welfare programmes is that individuals who are genuinely and unavoidably in need would get less help. Thus, while eliminating these programmes might increase output, it will also eliminate the positive contributions that these programmes were making to fairness and other social goals.

Political Costs of Reducing Social Welfare Spending

Besides the social costs mentioned above, there are also political costs to reducing social welfare spending, as it is politically difficult to take away that to which people have become accustomed.

The Supply-Side Record

Supply-side policies were applied in the United States in the 1980s, where President Reagan’s administration marked a shift in macroeconomic policy from a Keynesian demand-side approach to a supply-side, strict money supply control approach advocated primarily by Robert Mundell and Milton Friedman. The plan to stabilise and improve the US economy was based on the following 4 points:

- reducing business taxes through investment tax credits and accelerated depreciation;
- reducing federal government regulation;
- reducing government spending, and;
- controlling the money supply.

These policies led to a more stable, healthy US economy. As a result of the supply-side fiscal incentives and deregulation, supply increased and induced changes in aggregate demand. The reduction in tax rates had a favourable effect on work incentives and on real GNP. Meanwhile, control of government spending coupled with strict control of the money supply, allowing it to increase only to match increases in productivity,
brought inflation to near zero levels. Increased productivity and reduced inflation were jointly achieved (Hosmand, 1995).

Supply-side policies have probably been most effective in Ireland, causing nothing short of an “economic miracle”. Since the late 1980s, when sheer desperation pushed the government into the arms of supply-siders, Ireland has been the most aggressive tax cutter and fastest-growing economy in Europe. After income tax rates were cut from 65 percent to 35 percent, Irish GDP growth has been more than double the EU average each year but one; since 1995, Irish growth rates have been more than double sometimes triple the EU average each year. Having one of the lowest corporate tax rates in the world led to a flood of foreign direct investment, with nearly half of all North American direct investment in Europe going to Ireland.

In 1999, its best year after the 1994 capital gains cut, Ireland grew at 11.3 percent while the EU averaged 2.9 percent; in 2003, its worst year and a year when the world economy struggled, Ireland grew at 1.4 percent, exactly double the EU growth rate. In 1997, unemployment figures moved out of double digits for the first time in more than a decade, dropping from 15.6 percent in 1993 to 3.9 percent in 2001. In 2003, the figure was 4.6 percent, while across the EU it was 8 percent.

Between 1980 and 1997, personal income tax revenues increased five-fold, from $1.2 billion to $5.1 billion. Ireland’s perpetual deficit crossed over into surplus in 1997, while national indebtedness went down from 93 percent of GDP in 1992 to 32 percent in 2003.

The Experience of Malta, a Small Island State

A number of supply-side policies were implemented in Malta over the past two decades. These included:

A reduction in the marginal income tax rates and in the corporate tax rates. In 1990, the highest income tax rates were slashed by slightly less than a half, from 65 percent to 35 percent. The corporate tax rates were also cut to 35 percent. The high tax rates in place before had led to a pervasive underground economy, to the extent that out of 138,000
registered taxpayers in 1986, only 185 paid tax rates of 65 percent. Government income tax revenue declined from Lm32 million in 1980 to Lm 27 million in 1986. The 1990 budget specifically stated that tax rates were being reduced partly to boost up government revenue, as other countries had done so and were successful.

Trade liberalisation. Up to the late 1980s, international business in Malta was constrained by exchange controls, import quotas and high import duties. As a result of restrictive policies, imports of goods and services decreased between 1980 and 1986 but this was accompanied by a simultaneous decrease in exports. In fact, while in 1980, exports of goods and services amounted to 84.4% of GDP, this figure went down to 67.7% in 1985. Also, whereas between the years 1976 to 1980, exports of goods and services increased by 57%, between the years 1980 to 1986, exports of goods and services decreased by 11%. Thus, the difference between exports and imports expanded during this period. These restrictions have been virtually totally removed and Malta is now a very open economy, with exports and imports being close to 100 percent of GDP. There are no export controls and Malta is fully open to imports from the EU.

Capital Programmes. In order for an economy to grow and be competitive, it must have a solid and modern physical and technical infrastructure, which meets the needs of business. Starting from the late 1980s, significant capital projects were undertaken in areas including electricity and water production, telecommunications, transport, education and health.

Privatisation. A number of public sector entities were privatised in sectors including financial services and communications.

Central Bank independence. In September 2002, Parliament approved the amendments to the Central Bank of Malta Act. The amended Act made price stability the primary objective of the Central Bank and established at law the Bank’s independence, giving it greater operational flexibility, while making the Bank more publicly accountable. It also brought into force the complete liberalisation of interest rates.

Introduction of the Value Added Tax (VAT). In 1995, VAT was introduced, widening the tax base and capturing activity not recorded by income tax.
Increased efficiency in tax administration and collection. The Inland Revenue Department is becoming increasingly vigilant in identifying tax evaders and the Tax Compliance Unit was set up to fight tax evasion.

Industrial restructuring. In Malta, the promotion of international competitiveness of industry is one of the more important elements of the government’s policy for industrial development, which was adopted in the third quarter of 2000. Malta’s industrial policy is tailored on the White Paper “Prosperity in Change: Challenges and Opportunities for Industry”. The White Paper provides a strategic overview for future industrial development and looks at the principal issues involved, mainly attracting additional foreign direct investment, expanding export activity, developing high value-added sectors, generating new employment opportunities and promoting joint ventures.

Constraints Arising from Small Size

While supply-side policies work in large countries, they are even more essential in small economies whose supply capabilities are often burdened by additional constraints. One reason for this is that in small economies, as the population is small, many government functions tend to be very expensive per capita, due to the fact that certain expenses are not divisible in proportion to the number of users. As a result governments of small economies often have to rely heavily on taxes to balance their budget.

In addition, the provision of basic utilities, including electricity, which utilises imported energy sources may have to be subsidised by the government in order to supply them at an internationally competitive pricing so as not to disadvantage domestic industry. Furthermore the prevalence of natural monopolies and market imperfections in small markets limit the government’s options with regard to privatisation.

A small domestic market also leads to market thinness, since in some areas the number of suppliers and the number of final buyers must necessarily be small. This applies to the commodity market as well as to the money market. This poses limitations on the extent to which market forces can lead to desirable allocation of resources. For example often one importer will be sufficient to provide for the whole market. Additional
suppliers may lead to excessive fragmentation and therefore to higher transport and distribution costs, adversely affecting the consumer.

It has often been observed that the cost of doing business in small economies, especially manufacturing, tends to be relatively high due to the need to import industrial supplies, often at relatively high per unit costs, and due to limitations with regard to spreading overhead costs. Thus to create an environment conducive to entrepreneurship in small states, government support is often warranted.

For these and other reasons, supply-side policies aimed at improving the proper functioning of markets and maximising their contribution to economic growth and development are probably even more essential in small states. The experience of Malta has shown that such policies do indeed generate entrepreneurship and economic effort, as evidenced by the liberal supply-side policies adopted during the nineties, compared to the demand management policies adopted during the seventies and early eighties.

**Conclusion**

Supply-side economics makes sense, since its underpinnings relate to the benefits of relying on market forces to maximise effort. This policy approach has had a number of successes across the world, ranging from large economies such as the United States to smaller ones such as Ireland. Malta has also attempted, with a fair amount of success, a number of supply-side policies. More effort needs to be expended in this direction.

Indeed, it may argued that in the case of small economies where market failure is more prevalent and the supply side is burdened with additional constraints, the use of supply-side policies is even more important than in larger countries. Such policies should be aimed at improving the proper functioning of markets and overcome the additional costs which such countries face due to their inability to reap scale economies and their lack of economic diversification.
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