

Intermediate Macroeconomics
Supply-side economics

<p>Base model from ch. 3 <u>Aggregate Production:</u> $\bar{Y} = \bar{A}F(\bar{K}, \bar{L})$ Labor supply, capital supply and A are fixed.</p> <p><u>Aggregate Demand</u> $Y = C + I + G$ $C = C_0 + C_Y^*(Y-T)$ $I = I_0 - I_r^*r$ $G = G_0$ $T = T_0$</p>	<p>Supply-side model <u>Aggregate Production:</u> $\bar{Y} = \bar{A}F(\bar{K}, L)$ Capital supply and A are fixed. Labor supply: $L^S = L(t)$ where t is the <u>tax rate</u> and $\partial L/\partial t < 0$. Example: $L^S = 10,000 - t^2$</p> <p><u>Aggregate Demand</u> $Y = C + I + G$ $C = C_0 + C_Y^*(Y-T)$ $I = I_0 - I_r^*r$ $G = G_0$ $T = T_0 + t*Y$</p>
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Ch. 3: Deficit reduction (higher T or lower G) --> increase national savings --> r falls --> increases I
 (increase in I will increase K and increase Y - We'll see that in ch. 8, but in ch. 3 K and Y are fixed).
 ==> Tax increases are 'good' (i.e. they increase investment).

Supply-side economics:

Increasing t will:

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|---|--|
| 1. reduce disposable income | --> <u>reduces</u> private savings (like in ch. 3) |
| 2. reduce labor supply --> reduce income | --> <u>reduces</u> private savings |
| 3. effect on public savings ($t*Y$; Laffer-curve) | --> public savings ?? |
| <hr/> | |
| = National Savings ??? | |

If labor supply effects are strong, meaning labor supply falls by a lot in response to tax increases,
 public savings fall which will reduce national savings.
 ==> interest rates RISE and investment FALLS !
 ==> Tax increases are 'bad' (i.e. they reduce investment).