**Supply Side Effects**

<table>
<thead>
<tr>
<th>Fiscal Policy</th>
<th>Demand Side Effects</th>
<th>Supply Side Effects</th>
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<tbody>
<tr>
<td>$\Delta \bar{q}$</td>
<td>Dismissed</td>
<td><strong>Also Important</strong></td>
</tr>
<tr>
<td>$\Delta \bar{T}$</td>
<td>But uncertain as to effects, hence usually ignored</td>
<td></td>
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</tbody>
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**Hypothesis**

- $\Delta \bar{q}$: Public investment = an outward shift in the production possibility frontier $\rightarrow$ AS shifts out
- $\Delta \bar{T}$: Disincentive to save, reduced private investment, the production shift inward $\rightarrow$ AS shifts left
Alternative production possibility curves
- Start with (C)
- Choices for the future
  - (b)
  - (c)

How can I shift the production possibility curve out?
- Increase public investment
  - but I may have to reduce private investment
- Increase private investment
  - but then reduce public investment

(c + I)
Private Spending

G
Public Spending
two supply side hypotheses

\( \Delta G > 0 \rightarrow \text{increased public investment} \rightarrow \text{AS shifts out} \)

\( \Delta T > 0 \rightarrow \text{less saving} \rightarrow \text{less investment} \rightarrow \text{AS shifts in} \)

\( (\Delta G + \Delta T) = 0 \) not affected 2.0

- Perkin

- text

examine only one hypothesis

\( \Delta T < 0 \) shifts AS out
Fiscal Policy and Aggregate Supply

- Fiscal Policy and Potential GDP

- Taxing people's incomes when they work or save weakens the incentives to work and save.
  - The quantity of labor and capital decreases which lowers potential GDP.

- A group of economists, supply-siders, believe that tax cuts strengthen incentives and increase aggregate supply.
Labor tax does not affect Eq. of labor.
- It does not affect but GDP.

Key question:
- In the aforesaid labor supply curve, real wage elastic?
Two Views of the Supply-Side Effects of Fiscal Policy

Fiscal policy has a large effect on \( AD \) and a large supply-side effect.

The Supply-side View

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Two Views of the Supply-Side Effects of Fiscal Policy

Fiscal policy has a large effect on $AD$ and a small supply-side effect

The Traditional View

Price level (GDP deflator)

Real GDP (trillions of 1992 dollars)

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