Chapter 15

Key Terms

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Extending the Analysis of Aggregate Supply

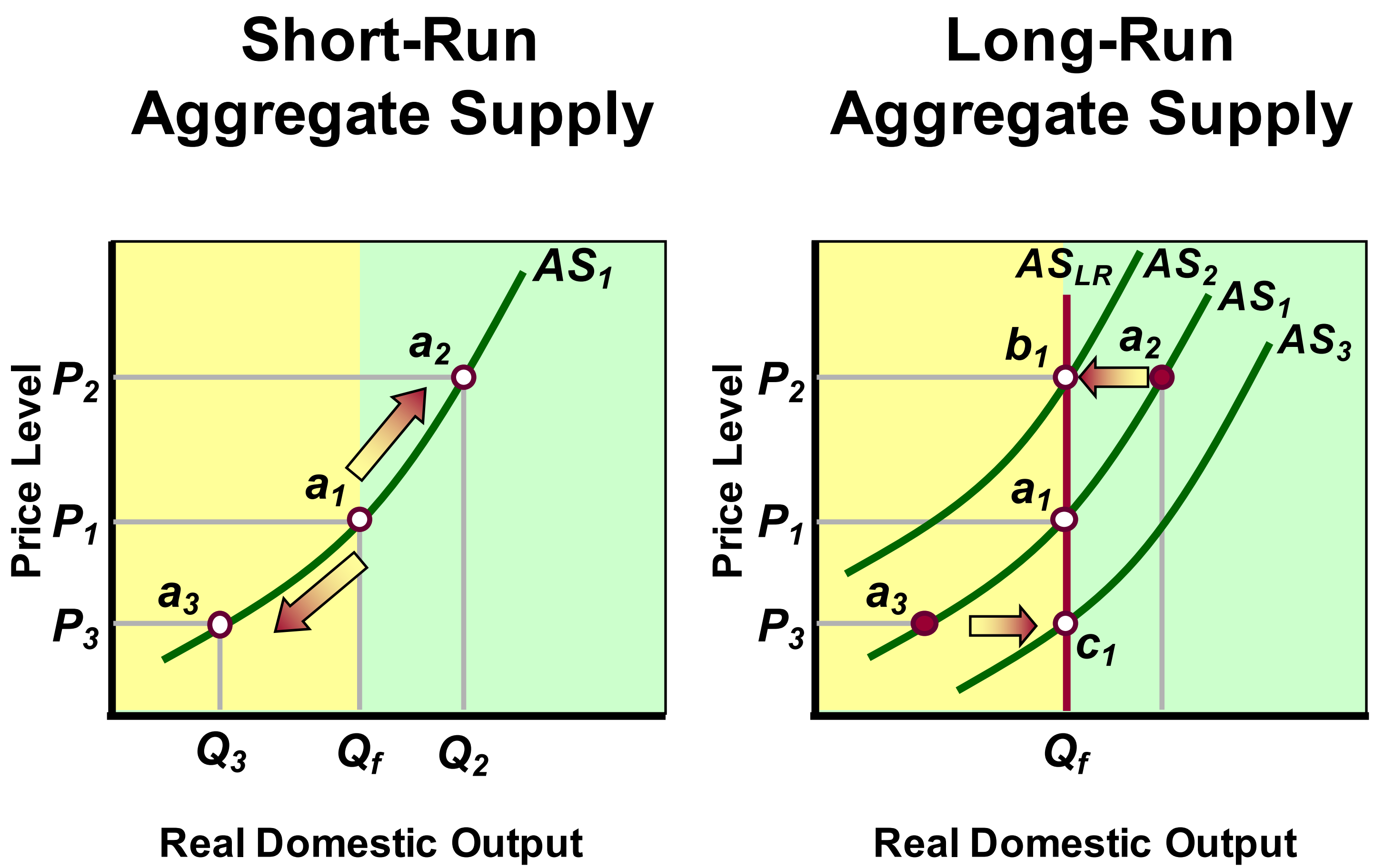
Chapter Objectives

- The Relationship Between Short-Run Aggregate Supply and Long-Run Aggregate Supply
- Applying the Extended AD-AS Model to Inflation, Recessions, and Unemployment
- The Short-Run Tradeoff Between Inflation and Unemployment (Phillips Curve)
- Why There is No Long-Run Tradeoff Between Inflation and Unemployment
- Relationship Between Tax Rates, Tax Revenues, and Aggregate Supply

From Short Run To Long Run

- **Short Run** – nominal wages and other input prices do not respond to price-level changes
- **Long Run** – nominal wages adjust to changes in the price-level
- **Short-Run Aggregate Supply** – higher prices increase output and lower prices decrease output (upward sloping *SRAS* curve)
- **Long-Run Aggregate Supply** – eventually higher or lower nominal wages that result from changes in the price level will shift the SRAS curve and return output to the full employment level (vertical *LRAS*)

From Short Run To Long Run



Chapter 15
From Short-Run to Long-Run
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Phillips Curve
Taxation and Aggregate Supply
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From Short Run To Long Run

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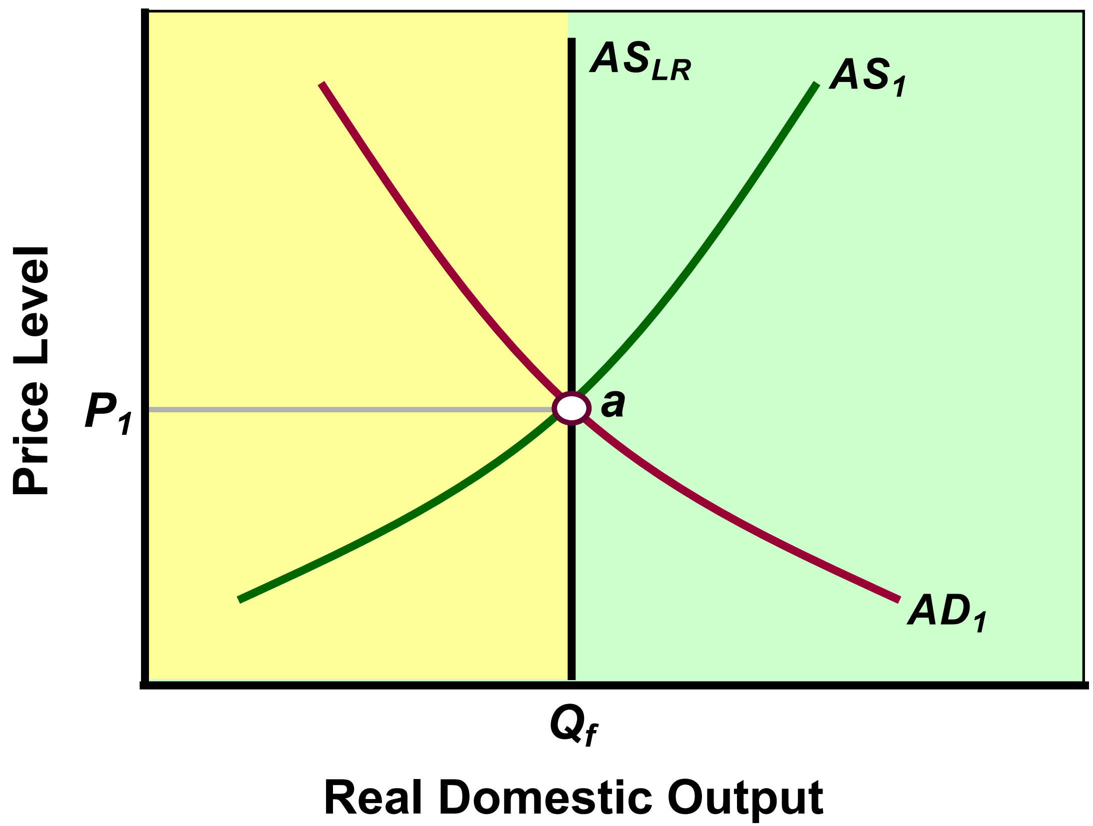
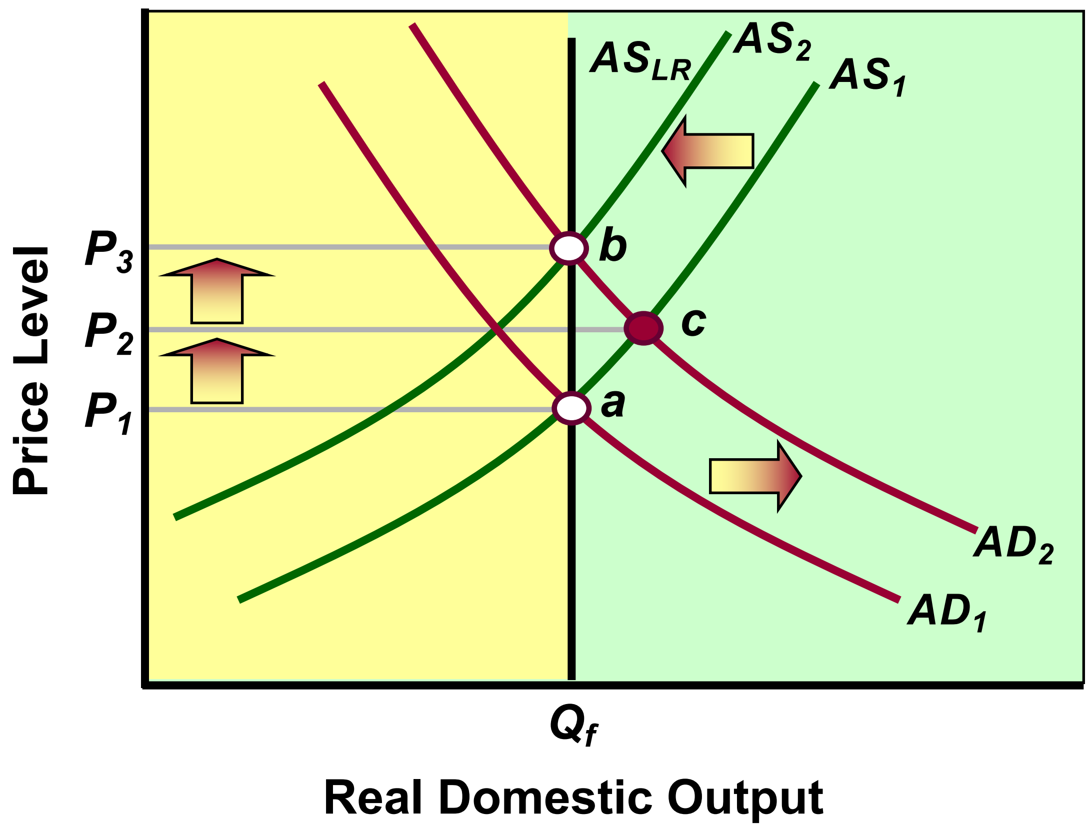
Equilibrium in the Extended AD-AS Model



From Short Run To Long Run

Demand-Pull Inflation in the Extended AD-AS Model



Key Terms
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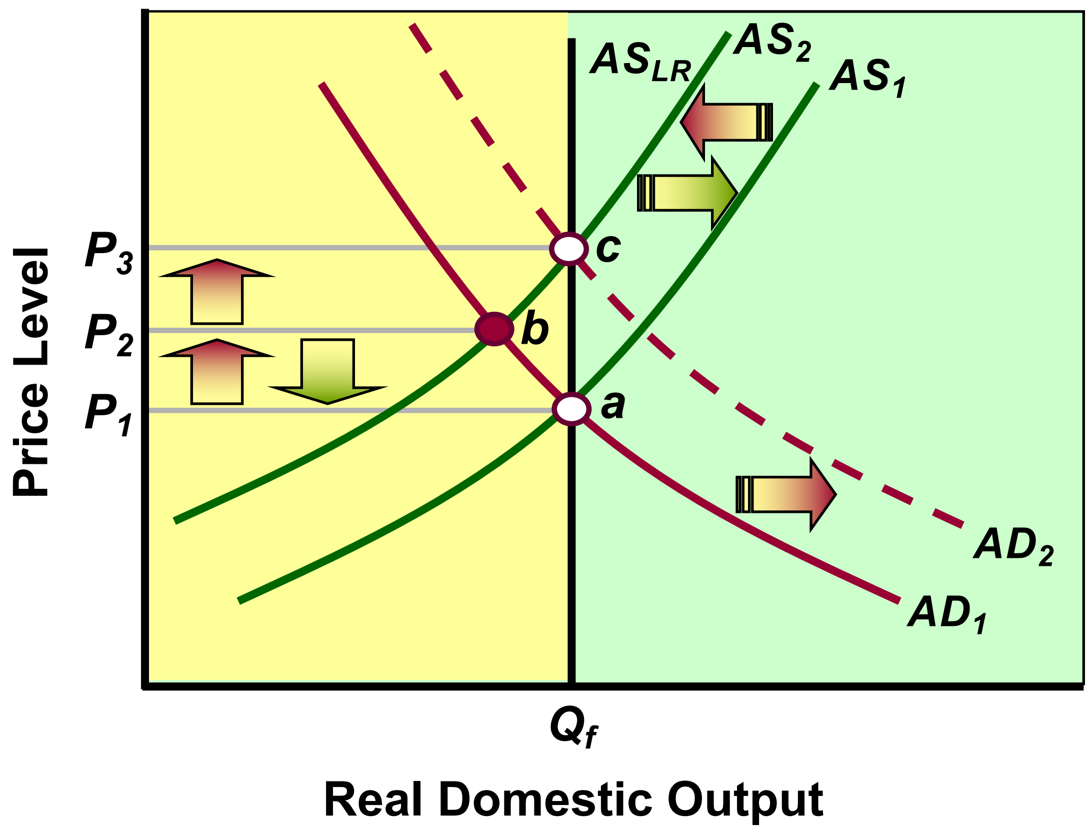
From Short Run To Long Run

Cost-Push Inflation in the Extended AD-AS Model

If Government Counters Recession With Spending…

If Government Ignores Recession…



Key Terms

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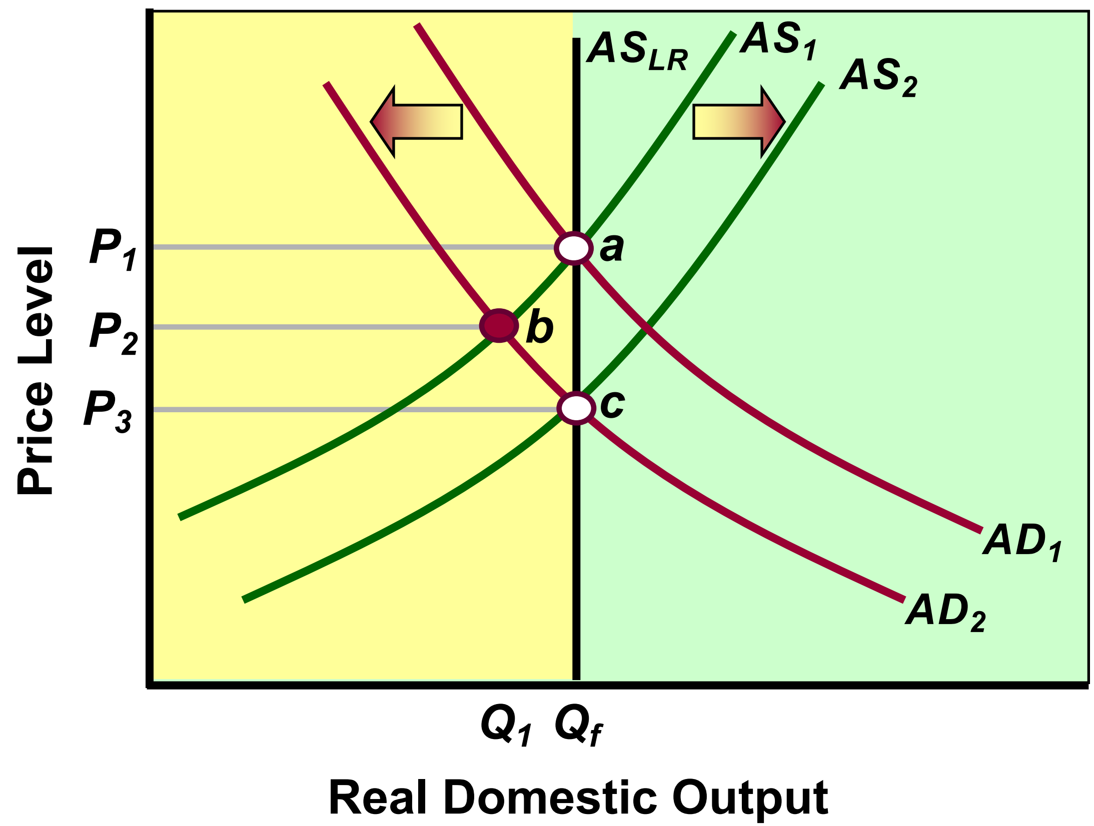
From Short Run To Long Run

Recession in the Extended AD-AS Model



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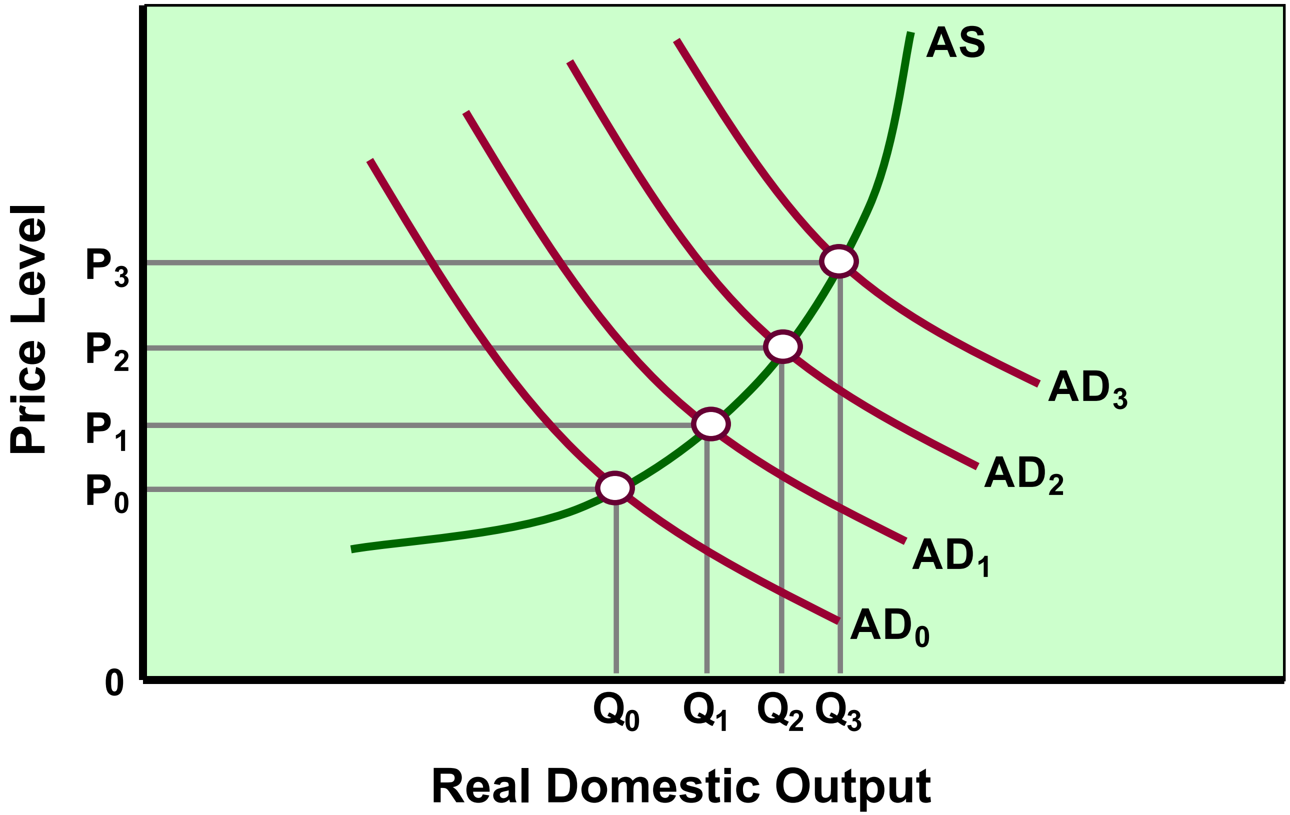
The Inflation-Unemployment Relationship

The Short-Run Effect of Changes on Real Output and the Price Level



The Inflation-Unemployment Relationship

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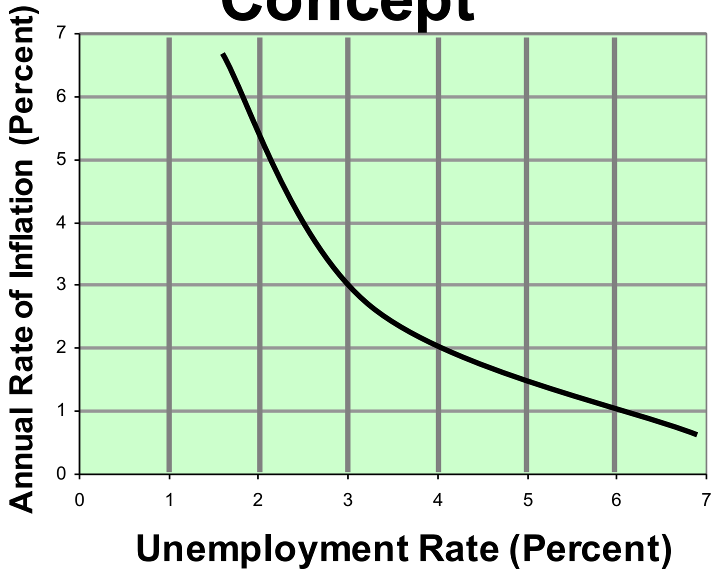
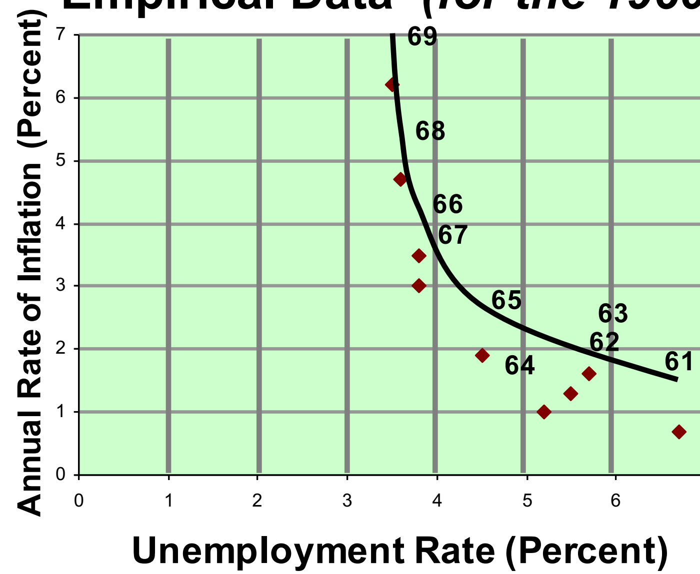
- **The Phillips Curve**
  - Inverse Relationship between inflation and unemployment
  - Expansionary fiscal or monetary policy = high inflation, low unemployment
  - Contractionary fiscal or monetary policy = low inflation, high unemployment

Concept



Empirical Data *(for the 1960s)*



Key Terms
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The Inflation-Unemployment Relationship

- **Adverse Supply Shocks and the Phillips Curve**
  - dramatic increases in resources costs that shift AS left
  - **Stagflation** – high inflation AND high unemployment (1970s, oil prices)
    - Phillips curve could shift out (right) during stagflation, or in (left) during periods of low inflation and low unemployment

The Inflation-Unemployment Relationship

- **Short-Run Phillips Curve** – shows the SR trade-off between inflation and unemployment
- **Long-Run Phillips Curve** – is vertical (same reason as LRAS) because nominal wages will adjust over time and employment will return to its natural level
  - In the LR there is no trade-off between inflation and unemployment! Unemployment returns to its natural level regardless of inflation rate!
- **Disinflation** – reductions in the inflation rate over time

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From Short-Run to Long-Run
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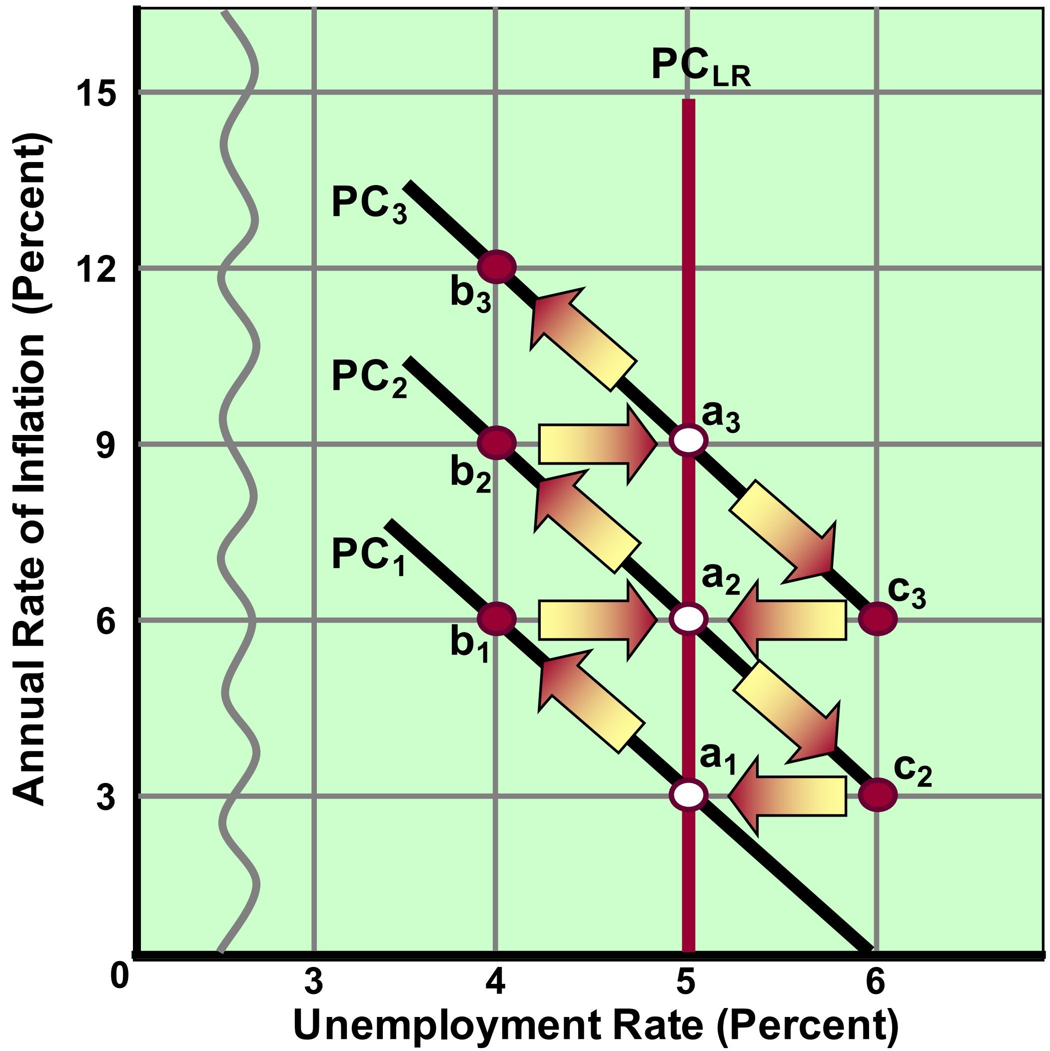
The Inflation-Unemployment Relationship

The Long-Run Vertical Phillips Curve



Key Terms
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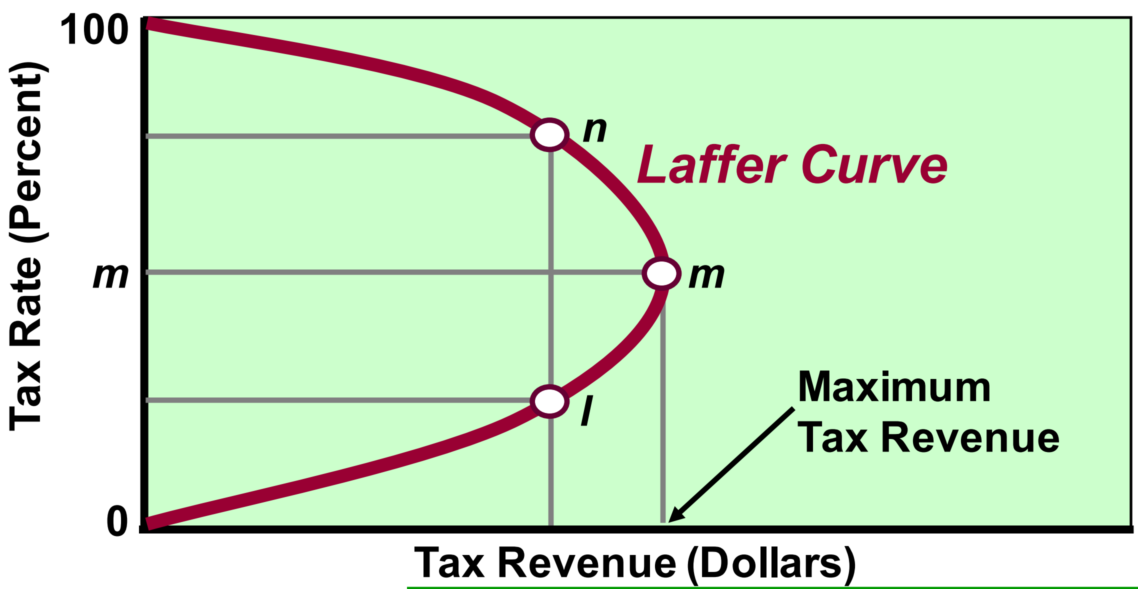
Taxation and Aggregate Supply

- **Supply-Side Economics** – theory that Gov policies (taxation) can cause shifts in SRAS and LRAS and therefore determine economic growth.
- **Tax Incentives to Work** – lower marginal tax rates encourage work (opposite true)
- **Tax Incentives to Save and Invest** – lower marginal tax rates encourage saving and investing (opposite true)
- **Bottom Line:** lower marginal tax rates encourage work, saving and investing. Workers enjoy better capital and productivity rises. LRAS shifts right which reduces inflation and unemployment!

Taxation and Aggregate Supply

- **The Laffer Curve** – tax revenue will increase as the marginal rate increases up to a certain point where the higher marginal rate discourages economic activity and actually reduces tax revenue.



Key Terms

End Show

Taxation and Aggregate Supply

- **Criticisms of The Laffer Curve**
  - **EX: Taxes** – if taxes↓ some people will work more (higher incentive), but others will work less (earn same income with less work!)
  - **EX: Inflation** – if taxes ↓ AD↑ which may wipe out the potential effects of any shift in AS!
  - **Position on the Curve** – how can we tell? Trial and error?

Tax Cuts for Whom?

A Supply-Side Anecdote

Last Word

- 10 People Have Breakfast Together for $100
- Charges are Divided in the Way Americans Pay Taxes
- 4 Poorest Pay Nothing, Fifth Pays $1, Sixth Pays $3, Seventh Pays $7, Eighth Pays $12, Ninth Pays $18, Tenth the Richest Pays $59
- Works Fine Until Price is Cut by $20 – How to Divide the Cut?

Tax Cuts for Whom?

A Supply-Side Anecdote

Last Word

- $20 Divided by 6 = $3.33 Resulting in Fifth and Sixth Being Paid to Eat Breakfast
- Cook Suggests Dividing Proportionate to Price Paid by Each
- Results in First 5 Paying Nothing, Sixth $2, Seventh $5, Eighth $9, Ninth $12, and Tenth Pays $52
- Each of the Paying 6 are Better Off Than Before

Tax Cuts for Whom?

A Supply-Side Anecdote

Last Word

- Conflict Erupts Over Who Got How Much Relief – The Majority Going to the Richest
- When Confronted the Richest Diner Didn't Come the Next Day.
- Surprise – They were $52 Short Without the Richest Payer

Tax Cuts for Whom?

A Supply-Side Anecdote

Last Word

- Morals: People Who Pay the Most Taxes Reap the Most Benefit From Tax Cuts
- Redistributing Tax Reductions at the Expense of those Paying the Highest Taxes May Produce Unintended Consequences!

Chapter 15

Chapter 15

Key Terms
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Key Terms

- short run
- long run
- Phillips Curve
- stagflation
- aggregate supply shocks
- long-run vertical Phillips Curve
- disinflation
- supply-side economics
- Laffer Curve

Chapter 15

Key Terms

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Next Chapter Preview…

Economic Growth

Chapter 16!