SUPPLY SIDE ECONOMICS

Presented by:-

LALIT CHANDRA DOLEY

V.P. & Associate Professor,

Dept. of Economics,

Silapathar College, Silapathar.

- **INTRODUCTION**

In the wake of oil crisis during 1970's and consequent supply shocks to the world economies, emerged a new line of economic thinking termed as *Supply Side Economics* (*SSE*) or *Reaganomics*. Now, we shall discuss the essentials of supply side economics and assess the impact of supply side policies upon economic activity over intermediate periods.

- **Essentials of Supply Side Economics**

The theoretical foundation of supply side economics rests upon the classical macroeconomic structure. The essential elements of supply side economics, as analysed by the writers like Arthur B. Laffer, Paul Craig Roberts, Jan Seymour and John Tatom, are as below :

(i) ***Validity of Say's Law of Markets*** : The supply side economic theory assumes that J.B. Say’s Law of markets is still valid. Whatever is produced is ultimately disposed of so that there is little possibility of over-production.

(ii) ***Determinants of output or supply*** : In this approach, it is maintained that the growth of output or supply over the intermediate period is the function of growth rates of factor supplies, factor productivity and the rate of technical change.

(iii) ***Classical interest-elastic saving and investment***: The supply side economics, like classical macro economic theory, assumes that both saving and investment are interest-elastic. The growth rate of capital is determined essentially by the incentives for investment and saving such as after-tax interest return.

(iv) Determinant of growth rate of labour: No doubt, the growth rate of labour in the long run depends upon the demographic factors but incentives in the form of after-tax real wage can also have a highly significant influence upon it.

(v) Free market system: The supply side theory recognises that excessive government regulation of business and industry can discourage capital formation and retard the growth of economic system. It is, therefore, proper to limit the government intervention only for the correction of market distortions and market failures. For the optimum allocation of resources and maximisation of production and welfare, the reliance should be placed upon private initiative and enterprise that can be stimulated through an appropriate system of incentives.

The supply side economists believe that the growth of output in the long and intermediate periods depends upon the supply factors. The increase in factor supply, improvement in efficiency of labour and other factors, modernisation and reduction in costs can bring about an increase in the supply of output. The most crucial policy element in this connection is the reduction in tax rates. It is presumed that the reduction in income tax rates, corporate tax rates and rates of excise duties can stimulate factor supplies; promote savings and investment, ensure larger return to entrepreneurs; encourage research in techniques; lower the cost of production; expand tax receipts of the government; and bring about a better allocation of resources. An increase in the supply of output, given the level of aggregate demand, can raise the equilibrium output and lower the level of prices. So the growth in output is supply- determined and not demand-determined. However, for the avoidance of deflation, if the aggregate demand is allowed to increase through an appropriate increase in the quantity of money, the growth in income or output will be demand-determined and not supply-determined.

In the classical model, saving and investment depend upon the rate of return (rate of interest). The supply-side economists made a slight modification when they assumed that after-tax rate of return is the prime determinant of investment and capital formation. The after-tax rate of return (γ_A) is the pretax rate of profit γ_p multiplied by 1 minus the rate of tax on profit (γ_{tp}).

$$\gamma_A = \gamma_p (1 - \gamma_{tp})$$

The supply side economists also believe that after-tax return for savings has a significant influence on the rate of saving. In this case the relevant rate of return is after-tax real rate of interest (γ_o) which can be determined by deducting the expected rate of inflation (P_E) from the after-tax nominal interest rate (γ_{N_A}). The after-tax nominal interest rate equals the nominal rate (γ_N) multiplied by 1 *minus* the rate at which interest payments are taxed (γ_{ti}).

$$\gamma_o = \gamma_{NA} — P_E$$

$$\gamma_o = \gamma_N (1 — \gamma_{ti}) — P_E$$

A reduction in the rate of tax can raise the after-tax rates of return and strengthen the incentives to stimulate investment. A high rate of inflation and high rates of personal income taxation or corporate profit taxation can weaken the incentives to raise savings and investment.

The supply-side economists also maintain that the supply of labour is responsive to changes in after-tax real wages $(w/p)_o$. It is equal to the product of real wage (w/p) and 1 *minus* the marginal rate of tax on income (γ_{ty}).

$$(w/p)_{\mathbf{o}} = (1 - \gamma_{ty})\, w/p$$

An increase in the marginal rate of tax on income will lower the after-tax real wage $(w/p)_o$ and vice-versa. A reduction in $(w/p)_o$ will reduce the supply of labour because of a direct relation between the real wage and supply of labour. On the opposite, a reduction in marginal tax rate on income will raise $(w/p)_o$ and increase the supply of labour. In this way, reduction in tax rate can provide sufficient inducement for the expansion of labour supply and consequent expansion in the supply of output.

The supply-side economics points out that the proliferation of government controls and regulation can cause a slowdown of the growth of economic system. There are three reasons for this. *First,* observance of government regulation may raise the cost of producing a given output. *Second,* the government regulation may retard capital formation. According to Lawrence Summers, the expenditure on pollution control in the United States absorbed about 20 per cent of net investment in 1979. *Third,* the proliferation of government regulations can discourage investment by increasing uncertainty about the future profitability of investment projects. Hence the private initiative and enterprise, promoted through a system of incentives and free market regime, can ensure larger production, wealth and welfare.

****

THANKS

***