Chapter 30: Fiscal Policy, Deficits, and Debt

When significant changes in aggregate demand plunge our economy into recession or drive it into runaway inflation, are we helpless passengers for the roller coaster ride? Fortunately, no. Fiscal policy allows policymakers to use changes in taxes and government spending to correct economic instability. Chapter 30 introduces fiscal policy as a means of economic stabilization and explores issues of the national debt.

During a recession, aggregate demand falls, creating a recessionary gap which reduces output and employment. The government can use expansionary fiscal policy, reducing taxes or increasing government spending (or both) to stimulate aggregate demand and restore the economy to full employment output. Expansionary fiscal policy creates a budget deficit, as the government spends more than its revenue in a year, and such deficits add to the national debt.

It is important to note that changes in government spending and taxes have different levels of efficacy. While increases in government spending have a full multiplier effect because they are fully spent in the economy, reductions in taxes are less effective. Because the marginal propensity to consume is less than 1, households will choose to save part of a tax cut and spend the rest. As a result, the multiplier will be lower for a change in taxes than for a change in government spending. Therefore, government would have to change taxes by a greater amount than it would have to change spending, if it wants to achieve the same effect in the economy.

The government uses contractionary fiscal policy to combat inflation, raising taxes, reducing government spending, or both. Because of the ratchet effect, prices that rise tend not to fall to their previous levels, so the focus is on halting the rise of inflation and reducing aggregate demand to reduce further pressure on prices. The rise in tax revenue and fall in government spending would reduce the deficit or even cause a budget surplus, which would reduce the national debt.

Because of the multiplier effect on changes in aggregate demand, the government does not have to fully fill a recessionary or inflationary gap with fiscal policy. The government can use the same multiplier in reverse. For example, if the multiplier is 4 and a $100 billion recessionary gap exists in the economy, government spending must only increase by $25 billion, which will eventually be multiplied by 4 to fully fill the gap.

Automatic stabilizers are policy programs whose actions are counter-cyclical and do not require specific action on the part of policymakers. For example, during recessions, government spending automatically increases for unemployment benefits, food stamps, and other programs when more people meet eligibility requirements. During inflation, the progressive tax system charges higher marginal tax rates for those whose incomes are rising faster than the inflation rate. While these automatic stabilizers can help to reduce the effects of economic cycles, discretionary fiscal and monetary policy are much more powerful tools to restore economic stability.

One potential problem of fiscal policy is the crowding-out effect. If government increases borrowing in order to conduct expansionary fiscal policy, the increased demand for funds in the loanable funds market can increase interest rates. Firms may respond by decreasing investment, reducing the effectiveness of the fiscal policy undertaken. Economists disagree about the strength of the crowding-out effect, as firms are already less likely to increase investment in a time of recession due to excess capacity.

The national debt is important primarily because of the effects of interest. Because ownership of the debt is concentrated in those with higher incomes, payment of interest increases the inequality of incomes. The payment of interest reduces government funds available to spend for other needs, and payment to foreigners who hold U.S. debt transfers those funds outside of the country. Crowding out is a much more important problem when the economy is at full-employment output, because increased government borrowing can reduce investment and compromise long-run economic growth. However, if the increased government spending is used for infrastructure improvements and research, long-run economic growth could be enhanced.

Material from Chapter 30 appears in several multiple-choice questions, and fiscal policy questions are commonly part of a free-response question on the AP Macroeconomics Exam. It is important to be able to graph the effects of changes in aggregate supply and demand, as well as the counter-cyclical effects of fiscal policy. Recognition of the appropriate fiscal policies to address recession and inflation, as well as the relative strengths of tax and spending policies, is vital for success in this portion of the AP Macroeconomics Exam.