Module Overview: Budget Deficits and the Public Debt

This module examines the economic consequences of chronic budget deficits and the potential dangers of an upward spiraling government debt.

Historically, Classical economists have argued that such budget deficits are bad and should be avoided except in wartime. In contrast, Keynesians believe that, at least during recessions, budget deficits are a necessary byproduct of an expansionary fiscal policy. Nonetheless, both Classical and Keynesian economists agree that chronic budget deficits are undesirable. The important policy question is this: How big a danger are these chronic deficits and a collateral soaring national debt?

By this module's end, you should be able to summarize and explain the major arguments for and against chronic deficits. You should also have a firm grasp on the difference between structural and cyclical deficits, be able to provide historical examples of each of these two kinds of deficits, and be able to explain the implications of each kind of deficit for the use of discretionary fiscal policy. Finally, you should be able to illustrate how budget deficits can lead to both trade deficits and the "crowding out" of private investment.

Key Questions:

1. Write the formula for a budget deficit.
2. What is the difference between government debt and a budget deficit or surplus?
3. Why do economists like to compare the debt to the size of the nations' gross domestic product or GOP?
4. What is the difference between the real and nominal budget deficit?
5. Suppose the nominal deficit is $100 billion, inflation is 10 percent, and total debt is $5 trillion. What is the real deficit?
6. What is the difference between the structural and the cyclical or passive deficit?
7. Define automatic stabilizers and provide three examples.
8. Suppose the gross domestic product is $10 trillion, the budget deficit is $100 billion, and the unemployment rate is seven percent, or one percent above the assumed full employment rate. Suppose further that the marginal tax rate is 30%. Which portion of the $100 billion deficit is structural and which portion is cyclical?
9. What is the central idea behind rational expectations theory?
10. What is the central policy implication of rational expectations theory?
11. Why is it important to estimating correctly the natural rate of unemployment important?
12. What are the three main ways of financing a budget deficit?
13. Why does the balanced budget multiplier have a value of one?
14. Use the Keynesian model to illustrate crowding out.
15. What is the primary problem with the "print money" option of financing the deficit?
16. Summarize the major arguments, pro and con in the budget deficit debate.