Deficits, Debt and Crowding Out

AP Macroeconomics | Unit 5 | flow vs stock, crowding out, long-run growth

1. Deficit vs debt

Definitions

Budget deficit = government spending − tax revenue in one year (a flow). **Budget surplus**: revenue exceeds spending. **National debt** = accumulated past deficits − past surpluses (a stock).

Debt $20T with deficits of 1.5, 1.2 and 0.8: debt rises to 21.5, 22.7, 23.5. A shrinking deficit still adds to the debt; only a surplus reduces it. In a recession, deficits widen automatically: tax revenue falls and transfer payments rise (automatic stabilizers).

2. Crowding out

Government borrowing raises the demand for loanable funds (or reduces their supply) → the **real interest rate rises** → **private investment falls** (a movement along private demand). In the example the real rate rises from 5% to 6% and private investment falls from 8 to 6.

3. Long-run consequences

- Less private investment → smaller capital stock → slower long-run growth (LRAS shifts right more slowly).
- Interest payments on the debt crowd out other spending.
- Repayment falls on future taxpayers.

A budget surplus works in reverse: more loanable funds, lower real rate, more investment, faster growth.

Where students lose points

1. Using “deficit” and “debt” interchangeably.
2. Saying a smaller deficit lowers the debt.
3. Shifting private investment demand for crowding out.
4. Using the nominal rate in the loanable funds market.
5. Confusing the budget deficit with a trade deficit.

Now practise it

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