

THE BALANCED BUDGET MULTIPLIER

Two types of fiscal policy to combat a recession are increased government spending (holding taxes constant) and cutting taxes (holding government spending constant). In both cases, such a policy approach entails running a budget deficit (or decreasing the budget surplus). There is a third type of fiscal policy that can eliminate a recessionary gap without an increased budget deficit (or decreased surplus). This is due to what is called the balanced budget multiplier (BBM). To use the BBM, government would increase spending (G) by the difference between the full employment level of output and income (Y_f) and the equilibrium level of output and income (Y_e). At the same time, taxes (T) would be increased by exactly the same amount, so that there is no increase in the budget deficit (or decrease in the surplus).

To see how this would work, suppose the following values (\$ in billions):

$$Y_f = \$2000 \quad Y_e = \$1600 \quad mpc = .75$$

Increase both G and T by \$400 ($Y_f - Y_e$). The increase in G would have a multiplier effect of 4 ($= 1/(1-b) = 1/(1-.75) = 1/.25 = 4$). $4 \times \$400$ means an increase of \$1600 due to the increase in G and the multiplier effect. But the increase in T by \$400 will decrease disposable income (Y_d) by \$400. Why won't this entirely offset the increase in G?

Because consumption (C) will decrease not by \$400 but by $.75 \times 400 = \$300$, since some of the decreased disposable income was not being consumed, but rather saved ($mps = .25$; $.25 \times 400 = 100$). So, accounting for the negative multiplier effects, the decrease in spending due to the tax cut will be $4 \times 300 = \$1200$. So we have:

