Automatic Fiscal Stabilizers

Narcis Eduard Mitu[1]
[1]Faculty of Economy and Business Administration, University of Craiova
mitunarcis@yahoo.com

Abstract: *Policies or institutions (built into an economic system) that automatically tend to dampen economic cycle fluctuations in income, employment, etc., without direct government intervention. For example, in boom times, progressive income tax automatically reduces money supply as incomes and spendings rise. Similarly, in recessionary times, payment of unemployment benefits injects more money in the system and stimulates demand. Also called automatic stabilizers or built-in stabilizers.*

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1. Introduction

Accommodation public policy is the kind of policy which does not have a public intervention nature. There may be only two such accommodation policy types: the discretionary type and the non-discretionary type. The best known accommodation public policies are those available to the Government (fiscal-budgetary policy) and to the Central Bank (monetary policy) with the role and functions of intervention in the economic market mechanisms in order to implement (induce, stimulate, maintain, correct, etc..) those processes and phenomena of economic, social nature and so on, which are supposed to lead to the achievement of the fundamental objectives of a country.

Fiscal health is essential for a stable economy. Affecting the consumer, saving and investment behavior, the fiscal policy affects the allocation of resources between the public and private sectors. Because of this, the fiscal policy, which is a public policy component, must assume the role of macroeconomic accommodation tool.

According to Baunsgaard and Symansky, (2009) ”fiscal policy can play an important role to help stabilize the economy during cyclical swings. Discretionary policy, however, typically involves implementation lags and is not automatically reversed when economic conditions change. In contrast, automatic fiscal stabilizers ensure a prompter, and self-correcting fiscal response. A simple rule of thumb applies: the larger government is, the larger are the automatic stabilizers.”Fiscal policy represents the set of rules, institutions and procedures that are designed to manage, in terms of public authority, the macroeconomic equilibrium in the real economy by controlling the trajectory of tax rates and government spending.

According to Dinga, the main features of this accommodation public policy are:

- It is the prerogative of the Government;
- It is applicable in the real economy (the goods and services market);
- It primarily concerns the adjustment of domestic macroeconomic imbalances;
- It is relatively rigid: its change is difficult and slow (the budget process is a relatively complicated and bureaucratic process);
- It is relatively effective: its implementation is ensured by force of law;
- The fiscal policy implementation effect is immediate (from the normative perspective, there are no lags (gaps) between the entry into force of the fiscal rule and this rule producing effects);

- It is strictly and completely regulated from the legal perspective (no persuasive tax instruments, but only normative tax instruments).

Under the market economy circumstances, it is preferable the case where most of the macroeconomic imbalances are allowed to adjust automatically, by the mere free play of market forces.

Such a mechanism, similar to the "invisible hand" of the economic competition area, can operate also for macro stabilization through fiscal policies. It is called automatic fiscal stabilizers and refers to the fact that, if the budget is designed to operate under conditions of equilibrium at full employment of production factors, then any changes to the operating parameters would initiate and maintain, as long as it is necessary, automatic mechanisms to return to the initial position.

2. How do the automatic fiscal stabilizers operate?

According to the broad meaning of the term, automatic stabilizers of an economy are forces that mitigate fluctuations which occur within the normal development trend. The causes of such deviations can be diverse: exogenous shock, real or monetary; purely endogenous pulsation of demand (linked to stocks and investment cycle).

Per the narrow sense of the term, automatic stabilizers concern only changes of revenues and expenditures attributable to cyclical fluctuations.

Automatic fiscal stabilizers are recognized by the following criteria:

- They lead the budget to surplus in the growth phase of the economic cycle and to deficit in the event of recession;
- They reduce the cash stock of the population in times of prosperity and increase it in times of recession (they tend to increase the population's demand for cash in times of prosperity and to reduce it in times of decline);
- Comes into action without waiting for decisions makers.

Let's assume a balanced budget, i.e. revenues are equal to expenses, under full employment. There may be two distinct cases of occurrence of imbalances in budgetary terms, but which reflect imbalances in the economic system as a whole:

A) the costs increase more than it was intended;

B) revenues increase more than it was projected.

We consider the cases one at a time:

A) *the costs increase more than it was projected*. In this case they exceed revenues, since the budget was designed under equilibrium conditions. If expenses become greater than revenues, the budget is in surplus, which means that the budget monetary injections into the economy outweigh the monetary budget levies in the economy. This means that, on balance, the money supply in the economy will increase. Increasing the money supply will result in the increase of the aggregate demand, which will also increase the aggregate supply, this resulting into increased budget revenues, upon the same taxation, thus to balancing the budget. Even though the budget was projected under equilibrium conditions for a certain degree of underemployment (unemployment), all automatic rebalancing will occur because aggregate demand increase leads to increase of the employment level, to align the new demand of aggregate supply, thus reducing unemployment, i.e. the reduction in unemployment benefit spending;

B) *the budget revenues increase more than it was projected*. In this case, the money levies to the budget, in the economy, exceed monetary injections from the budget to the economy, which, in the balance, results in lowering the existing money supply in the economy. This will reduce the aggregate demand, which will result in the reduction of aggregate supply, i.e. reduction of budget revenues equal to the initial spending. As in the previous case, the automatic rebalancing will occur even if the budget was not designed for the situation of full employment of the factors.

Therefore, changes in revenues and expenditures are influenced by both the evolution of the volume of economic activity (the position of the economy in the business cycle) and the "discretionary" decisions of the Governmental authorities.

Budget revenues and expenditures have a number of components that are influenced by the economic cycle. In terms of budget revenues, the majority of their constituents record cyclical fluctuations. Thus, contributions, taxes and tolls such as social security contributions, profit tax, value added tax, income tax or excise duty are strongly influenced by the position of the economy in the business cycle - recession or "boom". Regarding budgetary expenditures, they are not very influenced by the economic cycle, except for compensations and payments for unemployment benefits, which are strongly influenced by the business cycles.

The components of budget revenues and expenditures that are influenced by the economic cycle operate as automatic stabilizers, helping to smooth the business cycle and GDP volatility decline, with potential impact on long-term growth. Automatic stabilizers can operate both on the revenue side and the expenditure side of the budget.

In conclusion, if we consider the revenue side, where the economy is on the downward economic cycle (recession), budget revenues decrease, being collected less taxes (which are influenced by the economic activity). This fall stimulates aggregate demand, thereby boosting GDP. If the economy is in a period of "boom" of the business cycle, budget revenues grow cyclically, making the revenues of the agents to decrease, thereby limiting the expansion of aggregate demand. If we talk about the budget expenditure, automatic stabilizers operate normally through the system of compensation and benefits for the unemployed. Thus, if the economy is in recession and unemployment increases, increasing compensations and unemployment benefits stimulates the aggregate demand, and in the case of an economic boom, the decrease of these benefits limits the expansion of aggregate demand.

The automatic stabilizers (cyclical budget balance - the difference between budget revenues and cyclical budget expenditures) operate as a "brake" for economic activity when the actual GDP is above its potential level, namely as a "stimulus" for economic activity in periods when the actual GDP is below its potential. The actual GDP is "forced" to automatically stabilize.

The mechanism described works more powerfully as the tax system is more progressive.

3. Conclusions

Fiscal policy rules based on automatic stabilizers show some clear advantages. Incidental public revenues and expenditures (contingent-states), such as unemployment costs, amortize the economic fluctuations without delays in obtaining information and implementation. In addition, the impact of automatic stabilizers is short, and if they operate symmetrically over the business cycle they do not contribute to the deterioration of the structural budgetary position.

Altăr, Albu, Necula and Bobeică (2009) emphasize that "automatic stabilizers are natural means to reduce variations in the economic activity. However, given that some countries, especially small ones, may face a monetary position effect at the national level, there is still the need for an active fiscal policy. Given the arguments such as synchronization problems, irreversibility and uncertainty of the models, the use of discretionary fiscal policy measures for stabilization should be limited to exceptional situations: deep recession, high risk of economy overheating or accelerating of inflation".

Also Baunsgaard and Symansky (2009), note that „with large fiscal stabilizers, implementation is timely and gradual as tax and expenditure react in a countercyclical manner to changing economic conditions. From a fiscal sustainability perspective, automaticity also provides a timely reversal of any fiscal expansion—the fiscal loosening in bad times is automatically followed by a tightening in good times. This may enhance the impact of a fiscal expansion on demand with respect to discretionary action, as the latter may raise solvency concerns and affect interest rates.” On the other hand, ”there seems to be a case to increase the automatic stabilizers, not only in advanced countries but also in low-income and emerging market countries, where empirical evidence points to the prevalence of procyclical fiscal policies. To the extent this procyclicality reflects a bias in discretionary fiscal policy, enhancing the automatic stabilizers would provide some countercyclical pushback.”

The issue of automatic fiscal stabilizers should be treated with caution because the within the mechanism presented there may occur (and intervene in real life) factors and disturbances that make automatic rebalancing sometimes jeopardized. The size of automatic stabilizers is closely linked to the tax system (progressive or flat) and the sector's share in GDP. However, given that discretionary Government interventions are usually destabilizing in short-term, having a stabilization impact only on long-term, there is desirable a consistent blend between automatic fiscal stabilizers and response actions of the state budget.

Automatic stabilizers provide an appropriate fiscal response to the type of output gap under the impact of various shocks (demand, offer, temporary or permanent). However, equally important is to see the effectiveness of automatic stabilizers per the specificity of each country to its own structure, its own characteristics. Estimates show that the stabilizing function of these variables on the output and inflation under the impact of various shocks gives different results in different states. Therefore, it is possible that in some countries the effect of automatic stabilizers is not enough.

The Government sector's ability to contribute through automatic stabilizers to smoothing the business cycle is relatively low in Romania, compared to other European countries. The size of automatic stabilizers in Romania compared to other European countries is significantly reduced. Automatic stabilizers are more effective in countries where taxation has a pronounced progressive character. Due to weak automatic stabilizers, our country would need the possibility of implementing discretionary fiscal stimuli (higher structural deficit) stronger in times of recession to help the economy out of recession faster and return it to its potential.

The fact that Romania had a pro-cyclical fiscal policy that forced it to be just as pro-cyclical rather than countercyclical during the crisis started in 2008 is already a known fact. The current projection of the accommodation policies (particularly the fiscal policies) is almost entirely of discretionary type. This means not only an increased fiscal-budgetary instability and higher adjustment costs (including from the fiscal management perspective) during the execution of the general consolidated budget. According to Dinga, "the predominant discretionary nature of fiscal policy in Romania is generated mainly by the reduced capacity of macroeconomic forecast, by the emerging nature (i.e. non-Orthodox) of the economic growth in Romania but also by political reasons." Therefore no serious intentions are seen for introducing automatic fiscal stabilizers in the projection, implementation and monitoring of fiscal policies, to react without additional costs. Lack of complete information systems correlating the raw data from the Ministry of Finance clearly hampers the development of real macroeconomic default implementation of automatic fiscal stabilizers in optimal conditions.

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