

THEORETICAL CONSIDERATIONS REGARDING THE AUTOMATIC FISCAL STABILIZERS OPERATING MECHANISM

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This paper examines the role of Automatic Fiscal Stabilizers (AFS) for stabilizing the cyclical fluctuations of macroeconomic output as an alternative to discretionary fiscal policy, admitting its huge potential of being an anti crisis solution. The objectives of the study are the identification of the general features of the concept of automatic fiscal stabilizers and the logical assessment of them from economic perspectives. Based on the literature in the field, this paper points out the disadvantages of fiscal discretionary policy and argue the need of using Automatic Fiscal Stabilizers in order to provide a faster decision making process, shielded from political interference, and reduced uncertainty for households and business environment. The paper conclude about the need of using fiscal policy for smoothing the economic cycle, but in a way which includes among its features transparency, responsibility and clear operating mechanisms. Based on the research results the present paper assumes that pro-cyclicality reduces de effectiveness of the Automatic Fiscal Stabilizer and as a result concludes that it is very important to avoid the pro-cyclicality in fiscal rule design. Moreover, by committing in advance to specific fiscal policy action contingent on economic developments, uncertainty about the fiscal policy framework during a recession should be reduced. Being based on logical analysis and not focused on empirical, contextualized one, the paper presents some features of AFS operating mechanism and also identifies and systematizes the factors which provide its importance and national individuality. Reaching common understanding on the Automatic Fiscal Stabilizer concept as a institutional device for smoothing the gap of the economic cycles across different countries, particularly for the European Union Member States, will facilitate efforts to coordinate fiscal policy responses during a crisis, especially in the context of the fiscal harmonization. The main result of this study is the developing of the definition of Automatic Fiscal Stabilizer.

Key Words Automatic Fiscal Stabilizers, Discretionary Fiscal Policy, Non-discretionary Fiscal Policy, Economic Cycle, Economic Crisis

JEL Code H12, H30, O23

I. Introduction

The contemporary economic crisis demonstrated that fiscal policy can be used by the governments as a macroeconomic tool in keeping the public deficit and debt under the Stability and Growing Pact (SGP) thresholds. By using the rights incentives, fiscal policy can have longer-term effects. In the same time, the contemporary economic crisis demonstrated the fact that the mistakes in fiscal policy can have severe consequences both economic and social with high recovering costs. The effectiveness of using fiscal policy for balancing the Gross Domestic Product (GDP) gap depends on policy makers' ability to correctly time policy changes and on the impact that fiscal policy changes have on the economy. By the mean of SGP, governments are free to use both discretionary and non-discretionary fiscal policies. By introducing a third threshold with referring to the national output to be respected from all the member states, SGP will give more importance to the non-discretionary component of the national fiscal policy, becoming a real instrument for achieving the UE economic growth and long term sustainability and stability.

The Automatic Fiscal Stabilizers (AFS) reflect some revenue and expenditure items which adjust automatically to cyclical changes in the economy. These changes will have a direct impact on the

income of businesses and households. The effectiveness of the Automatic Fiscal Stabilizers depends on how responsive taxes and expenditures are to cyclical changes, i.e. the progressive tax system. The Automatic Fiscal Stabilizers balance the fiscal budget when the macroeconomic output gap (GDP) increases or decreases. The fiscal relaxation in crisis time is automatically followed by a fiscal tightening in boom time. This provides an appropriate fiscal response when the GDP gap is caused by demand shocks. How to estimate the size of Automatic Fiscal Stabilizers is an important issue. Reaching common understanding on the methodology for estimating the Automatic Fiscal Stabilizers across different countries, particularly for the European Union Member States, will facilitate efforts to coordinate fiscal policy responses during a crisis, especially in the context of the fiscal harmonization.

Reviewing the literature in the research field the conclusion is that the mistrust on discretionary fiscal policy generated by actual economic crisis has called into question the automatic fiscal stabilizers concept, increasing the researcher interest in this issue, admitting its huge potential of being an anti crisis solution. However the current design of national fiscal policies is almost entirely discretionary type. There are no serious attempts to introduce fiscal stabilizers to automatically react without any lag and any extra costs for stabilizing the cyclical fluctuations by making desirable adjustments for the real economy instead of discretionary public fiscal policy to smooth the economic cycle. Furthermore, there are no systematic preoccupations for making a connection between the fiscal harmonization trend and the level of non-discretionary of national fiscal policy of European Union States.

In this context, the objectives of the study are the identification of the general features of the concept of automatic fiscal stabilizers and the logical assessment of them from economic perspectives. In this purpose the paper intends to answer to the following questions: How works the Automatic Fiscal Stabilizers? Which is the component of the public budget through the AFS has its largest effect on macroeconomic output: the expenditures or the revenues? Which is the importance of automatic stabilizers on the demand and supply sides? Does the automatic nature provide a timely reversal of any fiscal expansion? The nature of the Automatic Fiscal Stabilizer can be entirely non-discretionary type or it also involves discretionary actions? Which are the factors with influence on the Automatic Fiscal Stabilizers mechanism?

The result of this study is the developing of the definition of automatic fiscal stabilizer.

II. Literature analysis

The Automatic Fiscal Stabilizers may be defined as those types of public income and expenditure which are directly linked with the economic cycle. (Martner 2000: 32) The Automatic Fiscal Stabilizers represents an institutional device which provides the non-discretionary character for the fiscal instruments which are operationalized through it (Dinga 2009: 1-69). Its finality is to reduce the volatility of the macroeconomic output. AFS represent a structural institutional device, with a negative feed-back, stimulating the economy in periods of recession and moderating in booms, thus exercising a regulatory function. Its effectiveness depends on its rate and base of action. (Dinga 2009: 22)

Although the Automatic Fiscal Stabilizers are a Keynesian idea (Blanchard 2000: 69), in the last ten years before actual economic crisis, it has been not much discussed by researchers. Some authors suggest that discretionary fiscal policy can be stabilizing but the effects are small (Perotti 2002: 3-63; Blanchard and Perotti 2002; Romer and Romer 1994: 13-80). Some authors consider that automatic fiscal stabilizers are more effective in damping cyclical volatility although the effects are also small (Auerbach 2002: 1-50; Van den Noord 2000: 137-150; Comley, Anthony and Ferguson 2002: 45-73). In an empirical study of the effects of the fiscal policy, analyzing the importance of the Automatic Fiscal Stabilizers, some researchers found strong effects of changes in fiscal policy on economic activity (Fatas and Mihov 2000: 1-37).

Between very few authors who considered the real importance of Automatic Fiscal Stabilizers, Martner demonstrated in 2000 that the Automatic Fiscal Stabilizers help to stimulate the economy in periods of recession and moderate it in booms, thus exercising a regulatory function, also showing that Governments have the option of allowing these automatic stabilizers to operate without intervention, or strengthening or restricting their effects through discretionary policies (Martner 2000: 32-54). According to the same author, (Martner 2000: 32-54) the automatic fiscal stabilizers are the main tool for obtaining a national balanced budget in “normal” economic conditions. Another author (Auerbach 2002: 1-50) demonstrates that the most obvious problem with looking at fluctuations in tax revenues, spending, or their difference is that each of these aggregates, especially tax revenues, is sensitive to the economic cycle and changes occur without any active policy decisions. The author concluded that these changes may serve as automatic stabilizers, “but they need to be left aside in attempting to measure active policy changes”. According to Auerbach, the automatic fiscal stabilizers offer an alternative to discretionary fiscal policy. Some researcher’s studies demonstrate that revenues are more responsive to variations in output than expenditures, suggesting that it is through tax policy settings that automatic stabilizers have their largest effects on output and pointing that automatic stabilizers play only a very small role in the accumulation of net public debt (Kennedy et al 2004: 1-50).

According to some researchers, the contemporary economic crisis has shown that monetary policy may not provide a sufficient response. In this case discretionary fiscal policy may be used, but it has at least two disadvantages: it suffers from implementation lags, including a political decision-making process influenced by multiple (possibly contradictory) considerations and is not automatically reversed when the economic cycle improves, giving rise to a potential deficit bias (Baunsgaard and Symansky 2009: 1-26). According to some researchers, automatic stabilizers do not suffer from these shortcomings, ensuring in contrast a prompt and self-correcting fiscal response (Baunsgaard and Symansky 2009: 1-26; Fedelino, Ivanovna and Horton 2009: 1-15; Kennedy et al 2004: 1-50; Brondolo 2009: 3-38; Follette and Lutz 2010: 1-40). The conclusions of such studies is that the countries should avoid introducing procyclicality as a result of fiscal rules, as these would offset the effect of existing automatic stabilizers (Baunsgaard and Symansky 2009: 1-26). In the same year, some paper works provides guidance on how to decompose overall fiscal balances into cyclical and cyclically adjusted components, and how to interpret automatic fiscal stabilizers, clarifying the methodology for decomposing changes in overall fiscal balances into discretionary and “automatic” effects (Fedelino, Ivanovna and Horton 2009: 1-15).

The scientific literature provides quantitative estimates of the effects of the automatic stabilizers on the government budget and on the economy in The United States, for 2008-2009. (Follette and Lutz 2010: 1-40). The Automatic Fiscal Stabilizers are most commonly estimated with the elasticity approach. (Fedelino, Ivanovna and Horton 2009: 1-15).

Regarding the Romanian literature in the research field, it is notable the contribution of Dinga Emil, 2009 in identifying the logical properties of a discretionary public policy and of a non-discretionary public policy, in clarifying the criteria for determining and identification of it. It is also notable his contribution in identifying the sufficient predicates (attributes) which ensure the quality of the automatic fiscal stabilizer. A particularly important aspect of which the Romanian researcher was concerned is the formal description of the generic action of the automatic fiscal stabilizer in different assumptions of the variation rate action, and of the variation of the base action of this special institutional device (Dinga 2009: 1-69).

III. Research methodology

Considering important to clarify some conceptual issues general valid related on automatic fiscal stabilizers, this study is based on logical analysis and not focused on empirical, contextualized one. The study of the automatic fiscal stabilizers actions was made in an abstract way, generally

valid. As a result, the methodology used in this study has an abstract character, based on evaluations of consistency, completeness and consistency of concepts, notions, classifications and interpretations. The use of formality in logical analysis of Automatic Fiscal Stabilizers, which may be thought of primarily as permitting the detailed mechanical checking of deductive arguments, is in fact much more significant in enabling the meaning of new concepts and notations to be located more precisely than they can be by informal means. The author considers this methodology being relevant in the AFS study because in all areas of knowledge, advances are dependent on the development of new terminology, concepts, or notations. These permit expression of those finer distinctions upon which the advance of knowledge so often depends.

IV. The results of the research

As argued above, discretionary fiscal policy is subject to potentially long inside lags, the delays between recognition of the need for fiscal stimulus or restraint and the design and implementation of the appropriate fiscal measures. Some of these inside lags occur administrative reasons, other inside lags occurs for political reasons. Administrative or political, long lags must be a strong argument against discretionary fiscal policy. The based on AFS non-discretionary fiscal policy can provide a faster decision making process, shielded from political interference, ensuring a timely fiscal response.

As the cyclical component of expenditure is smaller than that of revenue and the fluctuations in the cyclical component of the overall budget balance are largely explained by cyclical movements in revenue given the higher elasticity on revenues compared to expenditures (Martner 2000: 32-54), it means that revenues respond relatively more to variations in the macroeconomic output gap compared to expenditures. Among expenditures, only the transfers who are oriented toward income support like unemployment insurance benefits respond automatically to changes in economic activity. Result that it is through fiscal policy that Automatic Fiscal Stabilizers have their largest effect on macroeconomic output.

A tax system with rates rising with respect to income might, i.e. a progressive tax system, serve to stabilize output. Falling output, reducing marginal tax rates, could encourage business resulting greater labor supply which will raise public revenues in order to balance public budget. Raising output and marginal tax rates would have the opposite effect. Despite recent contributions to the literature, the strength of these effects is still not clear. The relative importance of automatic stabilizers on the demand and supply sides remains to be determined.

With large fiscal stabilizers, implementation is timely and gradual as tax react in a countercyclical manner for changing economic conditions. Political decisions are not required. The implementation lags are minimized. The fiscal relaxation in crisis time is automatically followed by a fiscal tightening in boom time. According to some researchers (Baunsgaard and Symansky 2009: 1-26), 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. This means that the automatic nature also provides a timely reversal of any fiscal expansion.

The Automatic Fiscal Stabilizer can be a byproduct of tax systems, which can have a different set of objectives relative to cyclical stabilization, depending of the policy maker ability which might reduce or delay the responsiveness of the economy to shocks. Even by its definition the Automatic Fiscal Stabilizer has a non-discretionary character, through the way it is designed, implemented and adapted on the needs of the economy, it reflects the policy maker ability, thus gaining a discretionary character. An increase in the Automatic Fiscal Stabilizers can be achieved through tax policy changes or by an appropriate design of fiscal rules which also involve discretionary actions.

The importance of Automatic Fiscal Stabilizers mechanisms depends on many factors. Based on the literature in the field, I have identified and systematized the fallowing main factors:

- the size of government, which means the weight of the public sector in the economy,

- the structure of public revenue
- the structure of public expenditures,
- the nature of the tax system i.e. the progressiveness of the tax system,
- fiscal rules,
- the transfer system,
- the unemployment benefit schemes,
- the degree of openness of the economy, etc.

All these factors imply structural characteristics which widely vary from country to country, and also over time. The size of Automatic Fiscal Stabilizers reflects not only the elasticity on revenues and expenditures but also the sensitivity of tax bases to changes in macroeconomic output. It results that reducing the progressiveness of the tax system means to decrease the effectiveness of Automatic Fiscal Stabilizers in smoothing the output gap. That's why the degree of smoothing of the economic cycle through the automatic fiscal stabilizers differs widely from country to country.

Fiscal rules can be an important factor for the functioning of the Automatic Fiscal Stabilizers mechanisms. Some authors agree that simple rules on the fiscal balance will act against the Automatic Fiscal Stabilizers (Baunsgaard and Symansky 2009: 1-26). This means the effect of debt ceilings, for instance, depends on whether they are initially binding. If debt is smaller than the ceiling, there is no immediate constraint on the Automatic Fiscal Stabilizers. If debt is close to the ceiling, a weakening in the cyclical balance would require offsetting discretionary tightening, limiting the stabilizers. We can use the same reasoning regarding the effect of introducing the fiscal balance ceiling. The Maastricht Treaty established a ceiling of 3% of GDP for the public budget deficit. As a result, if the cyclical fiscal balance deteriorates, this balance rule (or any rule involving a ceiling of the balance in nominal terms or in percent of GDP) will require offsetting discretionary tightening. The rule ensures that fiscal policy is countercyclical by allowing the automatic fiscal stabilizers to act freely. Discretionary fiscal interventions are allowed, too. Government is free to increase taxes or/and reduce expenditure every time the macroeconomic output goes down. This type of discretionary intervention is not an efficient one mainly because it generates uncertainty of the private environment. This seems to me not a surprising assertion, given that by definition an Automatic Fiscal Stabilizer must have a negative feed-back, so, logical, it must work countercyclical. Logic going on, we can assume that pro-cyclicality reduces the effectiveness of the Automatic Fiscal Stabilizer. **As a result we can assume that it is very important to avoid the pro-cyclicality in fiscal rule design.** However, the problem in this case would be the design of such a system for being able to react in a desirable manner, without supplementary costs and without delay, for smoothing the economic cycle.

V. Conclusions

Based on the researcher's results regarding the AFS operating mechanism, the paper concludes that the revenues respond relatively more to variations in the macroeconomic output gap compared to the expenditures. Logically going on, the conclusion is that the Automatic Fiscal Stabilizers have their largest effect on macroeconomic output through fiscal policy. An efficient fiscal policy must give priority to sustainability over time, also being able to adapt the budget balance to the economy movements. This is the reason we stand for a flexible institutional device (for instance a progressive tax system) with a constant rate of taxation instead of an annual budget balance rule. Constant taxes rates over the economic cycle can minimize the costs arising from distort taxes.

The conclusion of such a study is that the fiscal policy can and must be used for smoothing the economic cycle, but in a way which includes among its features transparency, responsibility and clear operating mechanisms. As the pro-cyclicality reduces the effectiveness of the Automatic

Fiscal Stabilizer, it is very important to avoid the pro-cyclicality in fiscal rule design. In the author's opinion only non-discretionary fiscal policy through Automatic Fiscal Stabilizers can provide a faster decision making process, shielded from political interference, which ensures a timely fiscal response. Political decisions are not required. Moreover, by committing in advance to specific fiscal policy action contingent on economic developments, uncertainty about the fiscal policy framework during a recession should be reduced.

Although investing may depend to a certain extent on current after-tax cash flow, it also depends on expectations of future profitability and future fiscal policy. Instead, the progressive tax system would not deep the uncertainty of the private environment, providing the balancing of the budget, acting like an Automatic Fiscal Stabilizers, in a counter-cyclical manner. Temporary job creation tax credits when unemployment exceeds a certain level would act like an AFS too. Anyway, to avoid adding to the deficit bias, the automatic measures could be symmetric, countercyclical: An expansionary measure during a recession could be offset by a tightening during the cyclical boom, leaving the fiscal balance unchanged over the cycle. The advantages of such transparent mechanism must be weighted against the cost of too often tax policy changes.

The fiscal policy do needs rules for controlling possible excesses in the management of public expenditure and tax rates, because of the dangers of populism and fiscal irresponsibility that may involves a discretionary fiscal measure. The disadvantages we discussed in this paper generate the need for continued precaution in the use of discretionary policy, deep concern for implementation of Automatic Fiscal Stabilizers, the objective of making automatic stabilizers more effective and the integration of better measures of fiscal balance into the discretionary policy process.

In the future paper we intend to decompose the fiscal policy into discretionary and nondiscretionary components to understand how the budget moves with output cycles and to design the operating mechanism of such institutional device which is the AFS.

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