COMMENTS ON SESSION 1
AUTOMATIC STABILISERS AND DISCRETIONARY FISCAL POLICY

AUTOMATIC FISCAL STABILISERS: WHAT THEY ARE AND WHAT THEY DO

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During the Great Recession of 2008-09, fiscal policy played an important role in leaning against the sharp downturn of aggregate economic activity. Utterly shunned as a stabilisation tool in the years before the crisis, fiscal policy – especially discretionary stabilisation – celebrated an impressive comeback. As the policy rates of monetary authorities approached or hit the zero lower bound, the conviction soon gained ground that fiscal stimulus packages were needed. By the end of 2008, the US and most countries in the EU had implemented or had decided to implement fiscal measures to boost aggregate demand.

The size of the discretionary fiscal expansions varied significantly across the Atlantic: the US swiftly deliberated massive increases in government expenditure, while European governments were more prudent in terms of both timing and size of their interventions. In 2009, the US budget deficit widened by around 3 percentage points in cyclically-adjusted terms (a gauge of discretionary fiscal policy making) as opposed to "only" 1.5 percentage points in the euro area.

In view of the global dimension of the crisis, the apparent difference between the discretionary fiscal commitment of the US and the EU gave rise to a trans-Atlantic debate about the appropriate size of fiscal stimulus packages: the US felt that Europe could do more, whereas European governments defended their comparatively prudent stimulus packages by pointing to their larger automatic stabilisers. Alongside the political debate, scholars of public finances intensified a decades-long discussion about the relative importance and relative merits of discretionary versus automatic fiscal stabilisation.

The three papers on which I was asked to comment on – "Fiscal Policy in the United States: Automatic Stabilizers, Discretionary Fiscal Policy Actions, and the Economy" by Glenn Follette and Byron Lutz, "Fiscal Policy in Latin America: Countercyclical and Sustainable at Last?" by Christian Daude, Ángel Melguizo and Alejandro Neut, and "The Impact of the International Financial Crisis upon Emerging Economies and the Performance of Discretionary Fiscal Policies: The Case of Argentina" by Ernesto Rezk, Ginette Lafit and Vanina Ricca – are part of this revived discussion. While focusing on different countries or set of countries and using different methodologies, they all engage in an empirical exercise that examines the role played by the two "classical instruments" of fiscal stabilisation – automatic and discretionary – over past and recent cycles, including the Great Depression.

Apart from the valuable insights that the three papers offer about fiscal policy making and fiscal stabilisation in the US and Latin America, they also highlight some important and still unsettled issues associated with the measurement and interpretation of automatic stabilisers. In spite of a relatively large and seasoned body of literature on automatic stabilisers, the three papers are fairly representative for the persisting lack of clarity about what automatic fiscal stabilisers actual are and how we should assess their effectiveness with respect to output smoothing.

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Except for the notional understanding that automatic stabilisers involve budgetary arrangements that help smooth output without the explicit intervention of a country's fiscal authority, views in the literature very much diverge about which elements or components of the budget effectively provide the bulk of automatic stabilisation over the cycle. This lack of consensus is also reflected in the three papers.

There are no doubts concerning unemployment benefits: their mechanics and impact is unambiguous. But then unemployment benefits are a fairly negligible part of the government budget in most advanced countries. The bulk of automatic stabilisation originates somewhere else; but where?

Very early work associated automatic stabilisation with the built-in adjustment of the *level* of revenues and expenditure in a counter-cyclical fashion (e.g., Musgrave and Miller, 1948). According to this view, which dominated the literature for a long time, automatic stabilisers produce a smoothing effect on output mainly because revenues decline during downturns and increase during upturns. Later work also pointed to the stabilising properties of progressive taxation (e.g., Auerbach and Feeberg, 2000) but stuck to the notion that automatic stabilisation was mainly due to automatic variations of revenues. Follette and Lutz as well as Rezk *et al.* follow this tradition. In their paper automatic stabilisation results from changes of revenues and expenditure produced (*i.e.*, unemployment benefits) by cyclical swings in economic activity.

An alternative interpretation of automatic stabilisation is centred on the size of government. Fatás and Mihov (2001) were among the first to argue that provided governments can borrow, automatic stabilisation, essentially resulted from the inertia of discretionary spending over the cycle. If governments did not borrow to keep expenditure levels steady in the face of cyclical down- and upswings, that is if expenditure where to follow output, the budget would provide little automatic smoothing. Daude *et al.* implicitly take this view. I say implicitly because their position is not fully consistent. When discussing the concept of automatic stabilisation they refer to cyclical swings of revenues. However, when estimating the size of automatic stabilisers they follow an approach developed by the OECD, more specifically by Van den Noord (2000) and Girouard and André (2005), an approach which explicitly argues that the strength of automatic stabilisation is largely determined by the size of government.

On the face of it, the different views about the actual source of automatic stabilisation could be interpreted as a purely semantic issue. After all, and by their very nature automatic stabilizers mitigate output fluctuations without any explicit government action. Hence, as long as they do their job, it may be rather futile to ponder about whether they act on the revenue or the expenditure side.

Nevertheless, the issue of substance becomes apparent when trying to assess the actual effect of automatic stabilisation on output. This can only be done by comparing two types of budgetary arrangements: one in which automatic stabilisers are taken to be on, the other in which they are taken to be off. It is in this context, when defining the benchmark against which the effect of automatic stabilisers is to be gauged, that the professed notion of automatic stabilisation makes a difference.

In the literature there is no commonly agreed view of what a "neutral" budget looks like. Also in this respect the three papers are representative. Those who argue that stabilisation mainly stems from cyclical changes in the level of taxation use a benchmark budget where both government revenues and expenditure are fixed in absolute values. This is the case for Follette and Lutz and to some extent also for Rezk *et al.*. Specifically, when simulating the effect of automatic stabilisers on output Follette and Lutz define the neutral budget as one in which revenues and expenditure are invariant with respect to output. Rezk *et al.* make reference to Musgrave and Miller whose analysis rests on the same assumption concerning a neutral budget. Daude *et al.*, by contrast, seem to think like Follette and Lutz and Rezk *et al.* but resort to a methodology that uses a different

benchmark, namely one in which both revenues and expenditure change in line with output. The same benchmark is also used by Brunila *et al.* (2003).

While equally arbitrary from an *ex ante* point of view, the two benchmarks have very different implications when it comes to assessing the degree by which automatic stabilisers help mitigate output fluctuations. If the benchmark is one in which revenues and expenditure vary in proportion to GDP, then proportional taxation does not produce any automatic stabilisation of output. In this case, stabilisation results from keeping expenditure steady. If on the other hand the benchmark is one where revenues and expenditure are fixed in level terms, any form of taxation that assumes a link between revenues and output will have a stabilising effect.

Can we reach any judgement about the relative merits or demerits of the two benchmarks? In my view yes. I would argue that invariant revenue and expenditure levels are neither a fair nor a useful benchmark for a "neutral" budget. To me neutrality means that budgetary aggregates remain neutral with respect to GDP, the macro variable that is expected to be stabilised. Invariant revenues and expenditure level do not score on this count.

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