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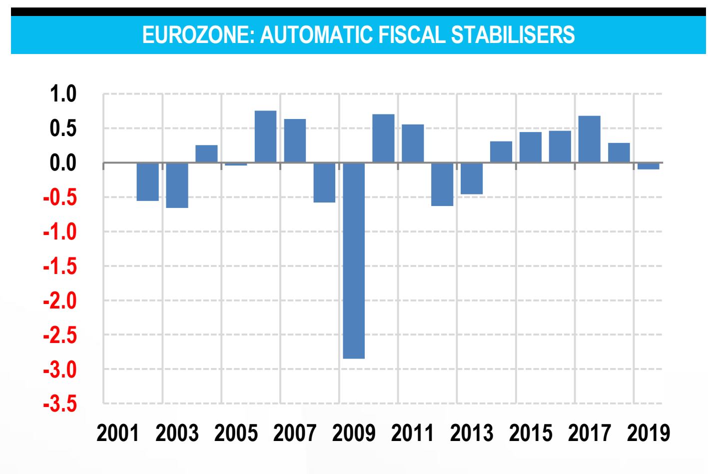
Eurozone: which role for automatic fiscal stabilisers?

■ Automatic fiscal stabilisers help cushion the impact of economic shocks on GDP via changes in government revenues (because of progressive taxes) and expenditures (unemployment insurance) ■ The limited remaining monetary policy leeway in the eurozone is fueling interest in the effectiveness of the automatic stabilisers ■ European Commission research confirms that, to some degree, automatic stabilisers iron out the impact of negative shocks on GDP ■ Whether that is enough is another matter. It warrants a debate on the role of discretionary fiscal policy in case of a recession.

The feeling of panic when sitting in front of a car which is about to get off the road is less overwhelming when you know it is fitted with airbags. Likewise, the presence of automatic fiscal stabilisers should underpin confidence of economic agents when the economy enters a recession. In the presence of progressive taxation, a drop in household income will lead to a smaller decline in after-tax income whereas public expenditures (unemployment insurance) will increase as unemployment picks up. This in turn will limit the drag of unemployment on household income and spending. The theory sounds familiar but to what extent is it the case in practice? Is the cushioning effect sufficient? These questions have gained importance in the context of the latest easing move of the ECB and the feeling that monetary policy leeway to support growth is now very limited. In addition, Mario Draghi has made a plea on the occasion of his September press conference that fiscal policy steps in to boost growth so as to help the central bank in achieving its inflation objective. A third reason for the renewed interest is the debate about a European budget, either to support growth in the long run or as a central cyclical stabilisation tool.

EUROZONE: AUTOMATIC FISCAL STABILISERS



Source: Ameco, BNP Paribas

The size of automatic fiscal stabilisers can be assessed based on the change of the cyclical component of the government budget balance. This corresponds to the difference between the overall budget balance and the cyclically adjusted deficit (or surplus). In a recent paper[i], the European Commission shows that following a positive 1% shock to GDP, about half is absorbed by the automatic stabilisers, essentially because government expenditures change less than GDP. However, a more fundamental question is what difference this makes to the development of spending and GDP when second round effects are taken into account.

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A counterfactual analysis in an earlier European Commission paper[ii] sheds light on this. The authors simulate a shock of an equivalent size, in terms of GDP contraction, as the Great Recession and compare the medium-term consequences in the presence of automatic stabilisers and in case they are switched off[iii]. They conclude that the degree of stabilisation is fairly significant: "*Our results indicate that automatic stabilisers could have ironed out 13 per cent of the drop of GDP in the euro area compared to a benchmark budget with fixed levels of revenues and expenditure*". The effect is even bigger (27%) compared to a situation where tax revenues and government expenditures are kept constant as a share of GDP.

Although it is far from negligible, whether this cushioning effect is sufficient is debatable. The reaction of households and companies to shocks in income and earnings depends, amongst other things, on whether the impact is considered to be short-lived or longer-lasting. The more overwhelming the policy reaction, the bigger the feeling that the income or earnings drop will be very temporary. This 'shock and awe' approach has been used by the ECB in its comprehensive set of easing measures announced in September: several decisions of limited scope, announced jointly, are supposed to generate a bigger impact than if they were introduced sequentially. Turning to fiscal policy, this raises several questions. Are households sufficiently aware of the existence and potential impact of fiscal stabilisers? Given the automatic nature of the stabilisers, does the absence of an announcement effect, which is present in case of a discretionary fiscal impulse, reduce its effectiveness in supporting confidence? Will economic agents incorporate in their decisions today the expected cumulative impact of the automatic stabilisers? These questions warrant a debate in the eurozone on the role of discretionary fiscal policy, as a complement to automatic stabilisers, in case of a recession: who does what, how much and how quickly?

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[i] Automatic fiscal stabilisers in the EU: size & effectiveness, European Commission, European Economy, Economic Brief 045, May 2019
[ii] Automatic fiscal stabilisers: What they are and what they do, European Commission, European Economy, Economic Papers 452, April 2012
[iii] The 'switching off' is simulated in two different ways. In one case, the 'automatic' decline in tax revenues and increase in government spending is neutralised by fiscal measures which keep revenues and expenditures at their pre-recession level. In a second scenario, taxes to GDP and government expenditures are kept constant as a share of GDP at their pre-recession level.