

## 20-2 Automatic Stabilizers in a Low-Rate Environment

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Until the 2008–09 financial crisis, macroeconomic stabilization policy focused nearly exclusively on monetary policy. It made good sense. In terms of theory, if nominal rigidities are at the core of inefficient output fluctuations, monetary policy is exactly the right instrument to counter their adverse effects. In terms of practice, monetary policy is nimble and, by institutional design, largely protected from political winds. In terms of outcomes, the Great Moderation—the stability of output and inflation over more than 20 years (from the mid-1980s to 2007)—seemed to confirm the wisdom of that choice.

By contrast, fiscal policy was a backwater. Governments were willing to let automatic stabilizers play out, even though their strength was the incidental result of decisions about the tax and spending structure that had little to do with stabilization. There were few attempts to improve them.

On the research front, large research departments at independent central banks and their local branches produced extensive research output on every aspect of monetary policy. Finance ministries responsible for fiscal policy had no parallel infrastructure, and the field of public economics focused largely on allocation and equity rather than stabilization issues.

Even before the crisis, however, neutral interest rates and, by implication, the policy rates set by central banks had steadily decreased, reducing the margin of maneuver of central banks. Whether the phenomenon is labeled secular stagnation, Japanification, or a long-term liquidity trap, today's rates are very low and expected to remain very low for a long time. In both Japan and the euro area, policy rates are negative, and, while the rates have become positive again in the United States, the margin of maneuver left for monetary policy is extremely limited. For advanced economies as a whole, long-term real rates are negative.

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This environment of low rates should be seen as a regime change, in which fiscal policy will have to play a major and likely dominant role in stabilization policy. It requires a fundamental reconsideration of discretionary fiscal policy and of automatic stabilizers and fiscal rules.<sup>1</sup>

In this Policy Brief we focus on automatic stabilizers and what we call “semiautomatic” stabilizers—stabilizing fiscal policies that operate according to preset rules.

Purely automatic stabilizers are movements in public spending and revenues coming from the interaction between existing spending and revenue schedules and economic fluctuations, without discretion or explicit triggers. Altering them significantly would require fundamental changes in tax or benefit structures that reflect deep political choices.

A better alternative is to develop semiautomatic stabilizers—tax or spending measures triggered by the crossing of a statistical threshold such as a low output growth rate or a high unemployment rate. A few semiautomatic stabilizers already exist—such as, in the United States, the extension of the length of unemployment benefits when the unemployment rate in a particular state exceeds some threshold—but they have only minor stabilization impacts.

We offer four observations about the design and implementation of semiautomatic stabilizers. The first regards the choice of triggers, output-based or unemployment-based. The second concerns the size of the hole left to fill by fiscal policy if monetary policy cannot be used. The third involves the division of tasks between automatic stabilizers and discretionary policy. The fourth takes up the choice between stabilizers working mainly through income and stabilizers working mostly through intertemporal substitution effects.

### **TRIGGER: UNEMPLOYMENT OR OUTPUT?**

Ideally, stabilizers should reduce deviations from potential output but not react to movements in potential output. If an increase in output reflects an increase in underlying productivity, a stabilizer that leads to a fiscal contraction in response to this increase will be counterproductive.

Existing automatic stabilizers respond to both output and unemployment. In the United States, about two-thirds of their response reflects changes in tax revenues, and thus depends mostly on output. About one-third reflects changes in transfer programs, in particular changes in unemployment benefits, and thus depends mostly on unemployment (see Russek and Kowalewski 2015).

In contrast, when designing semiautomatic stabilizers, one is free to choose the trigger, output or unemployment (more complex combinations are probably infeasible).

The evidence strongly suggests that the trigger should be unemployment rather than output. Take, for example, the decomposition between shocks with permanent effects on output and shocks with transitory effects on output used in the Blanchard-Quah (1989) decomposition. Based on reestimation of the implied structural vector autoregressions for the period 1950–2019, the proportion of the variance 8 quarters ahead accounted for by the transitory component is 11–25

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<sup>1</sup> A very good first pass at potential improvements in automatic stabilizers can be found in the book by Boushey, Nunn, and Shambaugh (2019).

percent for output and 53–81 percent for unemployment (the ranges reflect different specifications of deterministic trends). The mapping from shocks with permanent effects to shocks to potential output and from shocks with transitory effects to deviations from potential output is far from straightforward, but, to the extent that shocks with permanent effects are more likely to be shocks to potential output, these numbers suggest that the trigger should be based on unemployment rather than output movements.<sup>2</sup>

### OFFSETTING THE LARGE HOLE LEFT BY MONETARY POLICY

If, based on the argument of the previous section, the role of automatic stabilizers is to alleviate slumps in unemployment (rather than focusing on output and recessions), the next question is how much it might take to replace monetary policy, if monetary policy is indeed constrained and cannot help.

To think about it, we perform a counterfactual exercise and ask how much worse the slumps of the last 30 years would have been had monetary policy not been able to help.

Formally, we do the following. Let  $\Delta Y$  be the rate of change of aggregate demand and decompose  $\Delta Y$  between the part due to the change in the real interest rate,  $a(L) \Delta r$ , where  $a(L)$  is a distributed lag, and the part due to other factors, call it  $\Delta X$ :

$$\Delta Y = \Delta X + a(L) \Delta r$$

We can think of  $\Delta X$  as the growth that would have taken place if the real interest rate had remained constant, and thus construct it as

$$\Delta X = \Delta Y - a(L) \Delta r$$

Using Okun's law, and letting  $b$  be the Okun coefficient, we can then construct a counterfactual series for the unemployment rate, call it  $UC$  ( $C$  for counterfactual), using

$$\Delta UC - \Delta U = b (a(L) \Delta r)$$

And accumulating  $\Delta UC - \Delta U$  to obtain  $UC - U$ , and by implication  $UC$ .

We construct such counterfactual series for the unemployment slumps associated with the last three recessions. In each case, we look at the period starting with the first increase and ending with the final decrease in the unemployment rate, so 1989Q1 to 2000Q2 for the 1990 recession, 2000Q4 to 2007Q2 for the 2001 recession, and 2007Q4 to 2019Q3 for the 2008–09 recession. In each case, we assume that the actual and the counterfactual unemployment rates are the same at the start of each episode.

The distributed lag  $a(L)$ , giving the effect of a sustained increase in the real policy rate on output over 16 quarters, comes from a separate simulation of the FRB/US model under the assumption of neutral fiscal policy (i.e., in the absence

2 The caveats associated with the mapping of shocks with permanent or transitory effects to supply and demand shocks are well known. If hysteresis is present, demand shocks may have permanent effects. If the economy is in a state of secular stagnation, the permanent component may partly reflect demand shocks rather than potential output. Furthermore, even if the mapping to demand and supply shocks is appropriate, the adjustment to supply shocks may reflect a combination of changes in potential output and deviations from potential output.

of a feedback rule from debt to the primary deficit). It implies that a sustained 100 basis point decrease in the real policy rate has a steadily increasing effect on output, reaching 1.9 percent after 16 quarters. To construct the real policy rate, we use the difference between the federal funds rate and the one-year forecast of consumer price index (CPI) inflation from the Survey of Professional Forecasters. For the more recent episode, during which the policy rate reached the zero lower bound, we present two counterfactual series for the unemployment rate, one based on the real policy rate and the other based on the real shadow policy rate, using the nominal shadow rate calculation of Wu and Xia (2015).<sup>3,4</sup>

The results are shown in the three panels of figure 1. The shaded areas represent the quarters during which the economy was in recession, as determined by the National Bureau of Economic Research (NBER) dating committee.<sup>5</sup> The three episodes yield largely similar conclusions. First, because of the lags and the slowly building effects of interest rates, monetary policy did not make a substantial difference during the recession itself. Second, monetary policy did make a substantial difference to the overall unemployment slump with respect to both the size of the maximum increase in unemployment and the length of the slump, defined here as the number of quarters during which unemployment exceeded 6 percent. In the episode associated with the 1990 recession, maximum unemployment would have been higher by 1.3 percent and the slump would have been longer by 14 quarters. Put another way, the integral of the difference between the counterfactual and actual unemployment rate would have been 60 point-quarters more of unemployment. In the episode associated with the 2001 recession, the corresponding numbers would have been 1.7 percent and 21 quarters, leading to an integral of 40 point-quarters of unemployment. And in the episode associated with the 2008-09 recession, the corresponding numbers (using the shadow rate) would have been 1.5 percent and 16 quarters, leading to 103 point-quarters of unemployment.

These results have two implications. First, even if monetary policy is not constrained, there is substantial benefit to be had from fast-acting semiautomatic stabilizers because of the lags in the effects of monetary policy on output and unemployment. Second, if monetary policy is constrained, there are likely to be substantial gains from fiscal policy being used to accelerate the recovery.

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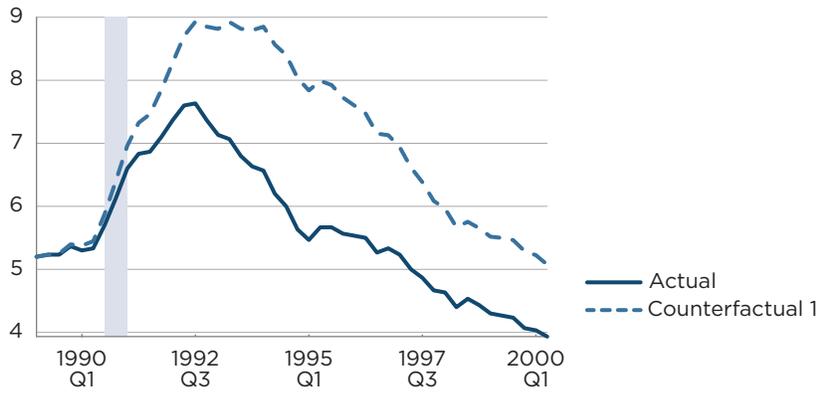
3 This exercise also comes with many caveats. While, in particular, we assume a constant real policy rate, the zero lower bound constrains the nominal policy rate. A constant nominal rate during a recession is likely to be associated with lower inflation and a higher real rate. To the extent that, in our counterfactual, inflation would have been lower, our computation understates the effect of monetary policy on unemployment.

4 The lowest value of the Wu-Xia index reaches -3 percent in 2014Q2.

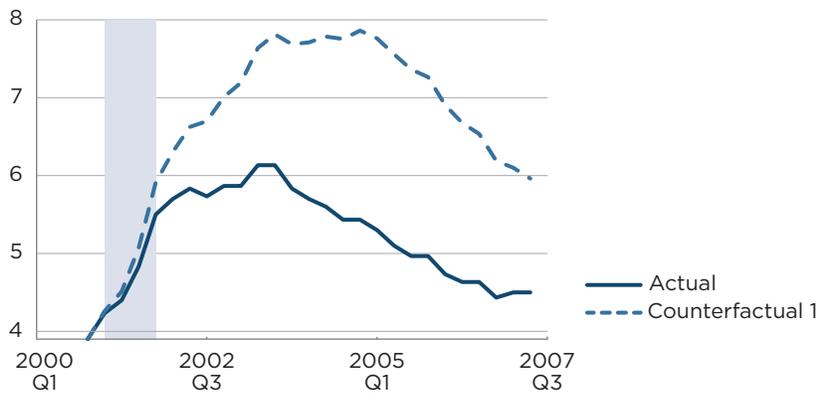
5 See [www.nber.org/cycles/recessions.html](http://www.nber.org/cycles/recessions.html) (accessed on January 25, 2020).

**Figure 1**  
**Unemployment, actual and counterfactual, for the episodes associated with the 1990, 2001, and 2008–09 recessions**

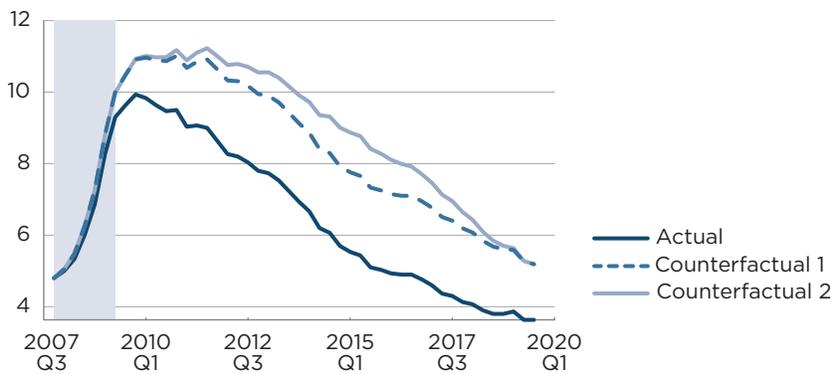
**a. 1990 recession**  
 percent



**b. 2001 recession**  
 percent



**c. 2008–09 recession**  
 percent



Source: Authors' calculations.

## AUTOMATIC STABILIZERS VERSUS DISCRETIONARY FISCAL POLICY

If fiscal policy is going to fill the large unemployment hole created by the limits on monetary policy, how should we think of the division of tasks between automatic stabilizers and discretionary fiscal policy? Should the role of automatic stabilizers be to provide a bridge to discretionary measures until political and implementation lags have worked themselves out, or should they play a sustained role for the duration of the slump?

The answer clearly depends on whether one can trust discretionary policy to eventually do the right thing.<sup>6</sup> Here, it is again useful to look at what happened in the past three recessions, recalling that the need for fiscal policy will be greater in the future if monetary policy is constrained more often than in the past.

Figure 2 plots the accumulated increase in the total federal deficit from the start of each episode, together with the contribution of automatic stabilizers to the total (using the Congressional Budget Office series for both the deficit and for automatic stabilizers).

In each case, not surprisingly given their mechanical nature, automatic stabilizers roughly mirror unemployment (figure 1). And in all three episodes, discretionary policy eventually comes into play, reinforcing the automatic stabilizers. The response of discretionary policy is, however, somewhat different across the three episodes. In the 1990s, discretionary policy played a limited role, being actually procyclical during one of the quarters of the recession and then turning countercyclical rather late in the slump. (The rest of the decade reflects the steady Clinton-Greenspan fiscal consolidation, which led to a large decrease in debt by the late 1990s.) The response of discretionary policy in the 2000s was quick and very strong, but reflected in large part a parallel agenda, namely, to decrease taxes more permanently, as reflected in the “Bush tax cuts” of 2001 and 2003. Similarly, the response of discretionary policy in 2008–09 was both quick and strong, reflecting the worry, specific to that episode, that the recession might turn into a depression and therefore require a very strong fiscal policy response (as well as the fact that interest rates had already reached their lower bound).

A much deeper analysis of other recessions and of the political process behind discretionary responses would be needed to reach a firm conclusion about the potential of discretionary countercyclical fiscal policy and how discretionary policies might be affected by semiautomatic stabilizers. What is true, however, of those three recessions is that discretionary policy eventually came into play. As we now discuss, this is relevant for the choice of semiautomatic stabilizer.

## WHAT TYPE OF STABILIZER?

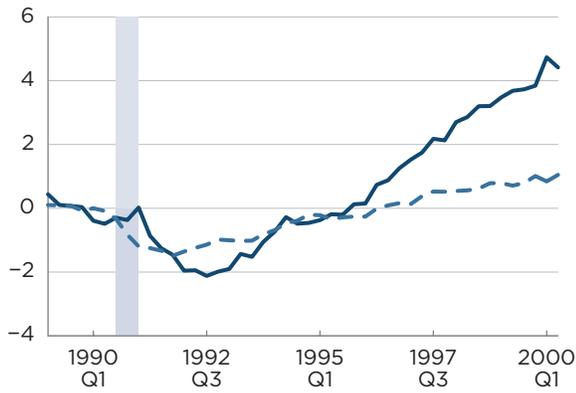
Potential semiautomatic stabilizers come in two forms. Those that work primarily through income effects to enhance household spending or to directly increase government spending. They include longer unemployment benefits, more generous food stamps, and various forms of direct stimulus payments to poor households as well as direct government spending measures like highway repairs or summer job programs. And those that work primarily through

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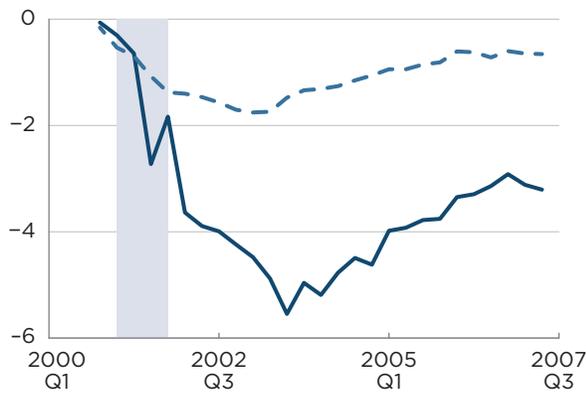
6 For a discussion, see Blinder (2004).

**Figure 2**  
**Total fiscal impulse, including contribution of automatic stabilizers**

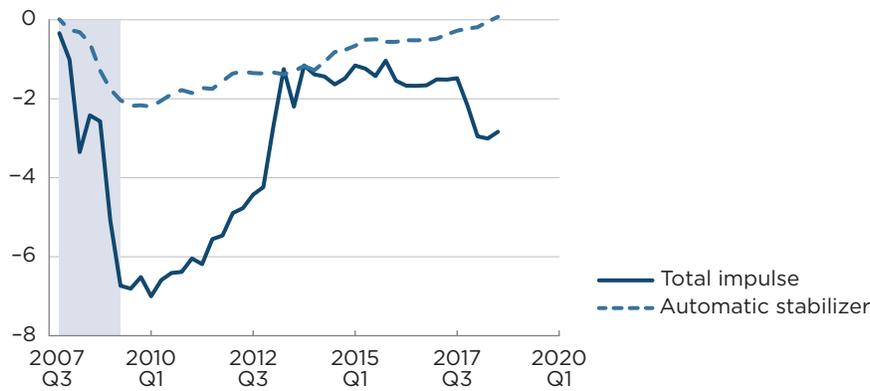
**a. 1990 recession**  
 percent of GDP



**b. 2001 recession**  
 percent of GDP



**c. 2008-09 recession**  
 percent of GDP



Source: Congressional Budget Office, [www.cbo.gov/about/products/budget-economic-data#8](http://www.cbo.gov/about/products/budget-economic-data#8).

intertemporal substitution effects, changing the timing of spending. Examples include temporary income tax credits (ITCs); similar tax credits for the purchase of consumer durables, such as the “cash for clunkers” program put in place in July 2009; and, in countries that have a value-added tax (VAT), temporary decreases in the VAT.

To the extent that semiautomatic stabilizers should work quickly and strongly, timing policies seem attractive. But, using the ITC as an example, they raise a number of questions. If the ITC is triggered by a slump and the slump is anticipated, isn't there the risk that anticipation of the ITC will trigger an earlier and possibly worse slump? Should the ITC have a clear and short terminal date, or be more open-ended? Will an ITC lead to a slump when it is removed and investment encounters an air pocket because the investment that would otherwise have taken place has been pulled forward?

To explore these issues, we use a simple model based on quadratic adjustment costs for investment.<sup>7</sup> Adjustment costs imply that investment is a function of the ratio of  $q$  (the present value of future marginal products, discounted at a rate that we take as given, reflecting the limits on monetary policy) to the price of investment, which itself is equal to the price of the capital good times 1 minus the ITC rate. We choose the adjustment cost parameter so that a 10 percent increase in  $q$  leads to an increase in investment of 2 percent of GDP. We close the model with a simplistic aggregate demand equation, with demand equal to investment plus a component taken as exogenous and following an AR(1) process.

It turns out that the impact of timing policies depends very much on the issue discussed in the previous section, whether discretionary policy eventually comes online and substitutes partially or fully for automatic stabilizers.

First consider the case when discretionary policy does not come online at all, so the only fiscal adjustment is from automatic stabilizers.

Figure 3 looks at the evolution of output after an unanticipated adverse shock, expected to decrease over time at a rate of 10 percent per quarter. It plots the evolution of output absent an ITC and under two alternative ITCs, one announced (and anticipated) to be in place for 1 quarter, the other announced to last for 5 quarters.

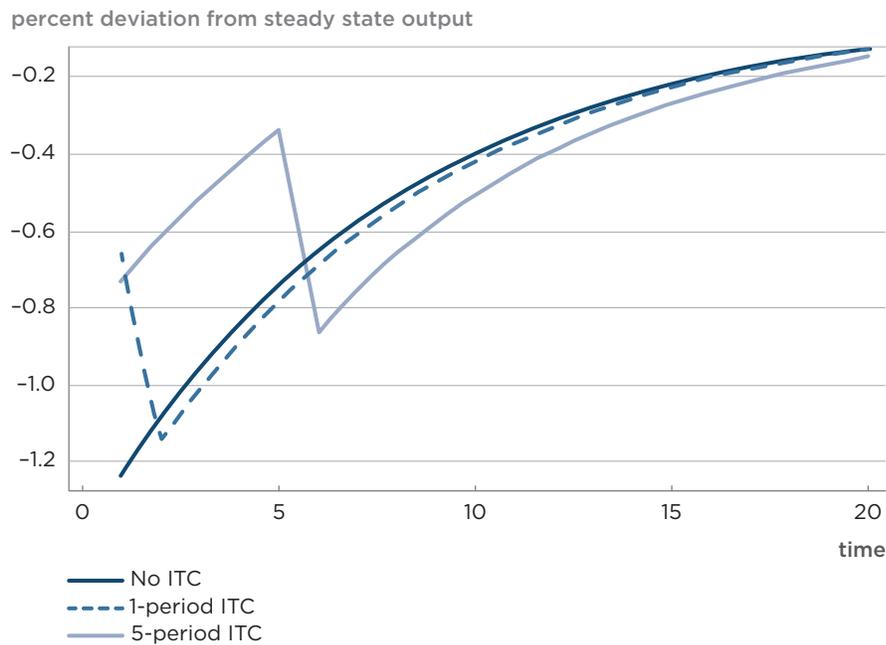
One might have expected the 1-quarter ITC to have a more powerful initial effect on investment and, in turn, on initial output. But that is not the case. The reason is that, while the longer duration of the 5-quarter ITC reduces the incentives to intertemporally substitute, the expectation of more sustained investment and output roughly offsets this first effect. For the same reason, when a slump is anticipated, the incentives to wait to invest are offset by expectations of stronger demand and output, and the effects roughly cancel.

Taken at face value, this has an important implication for the design of ITCs: The announced duration may not matter very much for the initial effect on output. Given the genuine uncertainty about the length of a slump, it is better to announce an open-ended ITC and keep flexibility in terminating it than to announce one with a short duration, which may turn out to end too soon.

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<sup>7</sup> An early study of the dynamic effects of the ITC under rational expectations was performed by John Taylor (1982), who looked at the effects of the Swedish investment funds system.

Figure 3  
**Effects on output of a 1-quarter and 5-quarter investment tax credit (ITC) in response to an adverse demand shock**



Source: Authors' calculations.

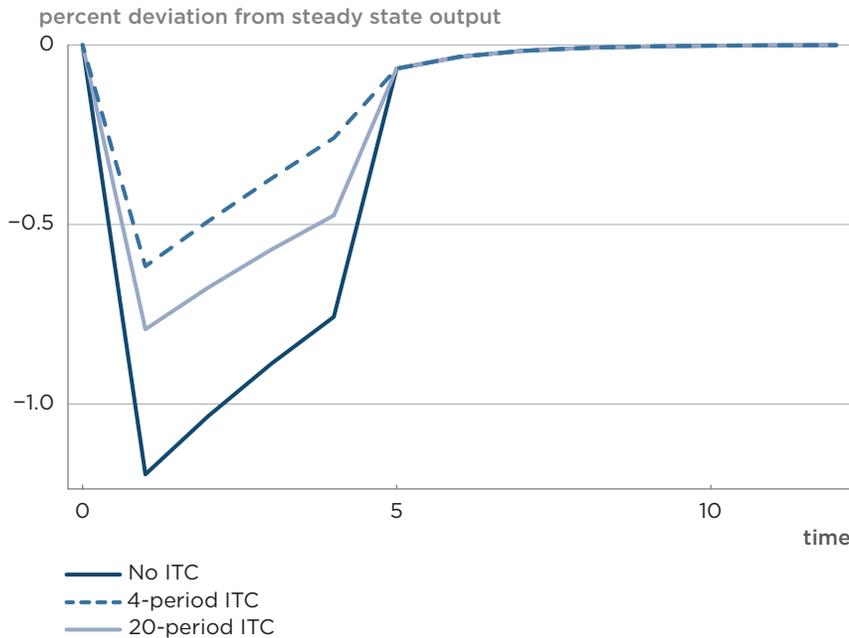
These conclusions, however, depend very much on our assumption that discretionary policy plays no role in the adjustment.

Take the other extreme case in which, when the political lags have worked out, the sum of stabilizers and discretionary policy is independent of the composition. In other words, discretionary policy, when it comes into play, is assumed to fill any gap left by automatic stabilizers. Then expectations of output from then on will be invariant to automatic stabilizers and the intertemporal effect will be the only one at work.

This is shown in figure 4, which illustrates the effects on output of a 4-period and a 20-period ITC under the assumption that discretionary policy responds (and is anticipated to respond) after 4 quarters, by offsetting the decrease in investment and increasing the speed of return to steady state (with the AR(1) coefficient on the exogenous shock decreasing from 0.9 to 0.5). In the absence of an ITC, output decreases by 1.2 percent; in the presence of a 20-quarter ITC, it decreases by only 0.8 percent; and in the presence of a 4-quarter ITC, output decreases by a bit more than 0.6 percent. Put simply, in the presence of anticipation of a discretionary policy response, the shorter the anticipated length of the ITC, the stronger the initial effect on output.

These are only examples of a general point. How to design semiautomatic stabilizers depends very much on the nature and the credibility of the general fiscal rules determining stabilization fiscal policy in general. With good fiscal rules or principles, semiautomatic stabilizers can serve as a bridge and rely on intertemporal substitution to increase their effect. If not, they have to act for a longer period, and in effect become a substitute for nonexistent fiscal rules.

Figure 4  
**Effects on output of a 4-quarter and 20-quarter investment tax credit (ITC) in response to an adverse demand shock and a delayed discretionary policy response**



Source: Authors' calculations.

## CONCLUSIONS

In a world where monetary policy cannot assume responsibility for stabilization policy, there is a strong need for fiscal policy to address stabilization issues. In this context, we have argued for the introduction of semiautomatic stabilizers. These stabilizers should be aimed at reducing unemployment slumps rather than output recessions; the hole left by the limits on monetary policy implies a large role for fiscal policy in general, and for stabilizers in particular; and the design of stabilizers, whether they focus on mechanisms that rely primarily on income or on intertemporal substitution effects, depends crucially on the general design of discretionary policy.

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