

## **Automatic Fiscal Stabilisers: What they are and what they do.**

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The global financial and economic crisis has revived the debate in the academic literature and in policy circles about the size and effectiveness of automatic fiscal stabilisers. Especially in the euro area where monetary policy is centralised and discretionary fiscal policy making is constrained by the EU fiscal rules, knowing the size and the effectiveness of automatic stabilisers is crucial. While automatic stabilisers are a fairly established concept in the fiscal policy literature, there is still no consensus about their actual nature and their effectiveness. This paper shows that differences in opinion mirror a deeper disagreement over how the budget would look like without automatic stabilisers. This issue is addressed by defining two types of counterfactual budgets giving rise to two different interpretations about the nature of automatic stabilisation. Simulations with a structural model confirm that the degree of smoothing is conditional on how the counterfactual budget, i.e. the budget without automatic stabilisers, is defined.

In particular, our simulations of shocks that closely capture the main stylised facts of the 2008-9 recession shows that the degree of stabilisation in the euro area is fairly significant, and more importantly, that it differs markedly across benchmarks. 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 degree of smoothing increases to 27 per cent when using a benchmark where revenues and expenditure follow GDP. Hence, dampening of cyclical fluctuations through the inertia of discretionary spending largely exceeds the smoothing effect of tax revenues