Q. What are automatic stabilizers and how do they work?

A. Automatic stabilizers are features of the tax and transfer systems that temper the economy when it overheats and stimulate the economy when it slumps, without direct intervention by policymakers.

Automatic stabilizers offset fluctuations in economic activity without direct intervention by policymakers. When incomes are high, tax liabilities rise and eligibility for government benefits falls, without any change in the tax code or other legislation. Conversely, when incomes slip, tax liabilities drop and more families become eligible for government transfer programs, such as food stamps and unemployment insurance, that help buttress their income.

Automatic stabilizers are quantitatively important at the federal level. A 2000 study estimated that reduced income and payroll tax collection offset about 8 percent of any decline in gross domestic product (GDP). Additional stabilization from unemployment insurance, although smaller than that from the tax system, is estimated to be eight times as effective per dollar of lost revenue because more of the money is spent rather than saved. Altogether, a 2016 study estimated that if transfer payments were reduced in size by 0.6 percent of GDP, US output and hours worked would be about 6 and 9 percent more volatile, respectively.

The Congressional Budget Office estimates that through increased transfer payments and reduced taxes, automatic stabilizers provided significant economic stimulus during and in the aftermath of the Great Recession of 2007–09, and thereby helped strengthen economic activity. That stimulus amounted to more than $300 billion annually in 2009 through 2012, an amount equal to or exceeding 2.0 percent of potential GDP in each year. (Potential GDP measures the maximum sustainable output of the economy.)

Automatic stabilizers also arise in the tax and transfer systems of state and local governments. However, state constitutions generally require balanced budgets, which can force countervailing changes in outlays and tax rules. These requirements do not force complete balance annually: they generally focus on budget projections rather than realizations, so deficits can still occur when economic conditions are unexpectedly weak. In addition, many governments have “rainy day” funds they can draw down during periods of budget stringency. Even so, most state and local governments respond to an economic slowdown by legislating lower spending or higher taxes. These actions are contractionary, working at cross-purposes with automatic stabilizers.

Background

What are automatic stabilizers and how do they work?

Further Reading

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