## Automatic Stabilizers

How much influence do governments still have over the economy? This is a question being posed for Australian voters. First, monetary policy is controlled by the central bank and is the main instrument for controlling the economy through the business cycle.

Second, fiscal policy controlled by the government is difficult to untangle. There's a double relationship between the budget and the economy. Because the budget contains "automatic stabilizers" (the two main ones being the progressive income-tax scale and the availability of unemployment benefits), the budget balance deteriorates automatically when the economy goes into a downturn and improves automatically when the economy is growing strongly.

This is a good thing because it means that, without the government lifting a finger, the budget acts to bolster private sector demand during recessions and restrain private demand during booms. That is, it acts automatically to stabilize - to some extent - the fluctuations in aggregate demand.

But these stabilizers happen regardless of policy. The important point for policy is what does the government do to change the fiscal position? If the government cuts tax rates or increases spending, this will worsen the budget balance but stimulate private demand. If the government raises tax rates or cuts spending, this will improve the budget balance but have a contractionary effect on private demand. These changes are fiscal policy.

If you were using the budget and fiscal policy as your main instrument for managing demand, you'd let the automatic stabilizers do their thing and then probably add your discretionary policy changes on the top, using them to reinforce the automatic stabilizers.

So if the economy was in recession, you'd let the automatic stabilizers turn the surplus into a deficit and then cut taxes and increase spending into the bargain.

If the economy was booming and inflation pressure was building, you'd let the stabilizers make the surplus ever bigger and maybe raise taxes and cut spending to make the surplus bigger still.

The more successful you were at using the budget to stimulate a weak economy, or hold back (restrict) a booming economy, the less you'd need to use monetary policy to cut interest rates in the first case or raise rates in the second.

The problem is that when an economy is booming governments don't let the automatic stabilizers kick in. The extra tax receipts, which slow consumption, are ploughed into government initiatives through government spending. The economy booms and more tax is collected. Monetary policy has to be tighter in order to keep the economy under control.

**Questions**

1. Explain what is meant by the term automatic stabilizers.

2. In China consumption is a small component of aggregate demand and exports are a large component. Will automatic stabilizers still help to control the Chinese economy?