

Economic Crisis, Automatic Stabilizers and Income Distribution

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In the current economic crisis, fiscal policy is widely seen to play a key role in stabilizing demand and output. A large part of the debate on the fiscal policy response to the crisis has focused on discretionary fiscal policy action in the form of fiscal stimulus packages. But there is a second source of fiscal expansion in an economic crisis: the workings of automatic stabilizers. Automatic stabilizers are usually defined as those elements of fiscal policy which mitigate output fluctuations without discretionary government action. In a previous paper², we assessed the contribution of automatic stabilizers to overall fiscal expansion and demand stabilization and compared automatic fiscal stabilizers in Europe and the US. The extent to which automatic stabilizers mitigate the impact of income shocks on household consumption essentially depends on the tax and transfer system which determines the way in which a given shock to gross income translates into a change in disposable income. Further, it is necessary to estimate the prevalence of credit constraints among households to explore how stabilization of disposable income translates into demand stabilization. All of this has been done in the previous paper.

It is the purpose of this paper to analyze the effects of economic crisis on the income distribution and the role of automatic stabilizers to cushion these impacts. We use microsimulation models for 19 European countries (EUROMOD) and the US (TAXSIM). We run two controlled experiments of macro shocks to income and employment. The first is a proportional decline in household gross income by five per cent (income shock). This is the usual way of modeling shocks in simulation studies analyzing automatic stabilizers. But economic downturns typically affect households asymmetrically, with some households losing their jobs and suffering a sharp decline in income and other households being much less affected, as wages are usually rigid in the short term. We therefore consider a second macro shock where some households become unemployed, so that the unemployment rate increases by five percentage points (unemployment shock).

For both scenarios, we compute several measures of inequality, poverty, richness and polarization in order to assess the distributional impact of economic crisis.

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²Dolls, M., Fuest, C. and Peichl, A. (2009): Automatic Stabilizers and Economic Crisis: US vs. Europe, IZA Discussion Paper No. 4310

This analysis enables us to explore how different groups of the society (according to income as well as other socio demographic variables) are affected by different downturn scenarios. Further on, we identify how much weight existing pre-crisis tax benefit systems put on different income groups to protect them from income and job losses. In the next step, we compare the effects across countries in order to evaluate the cushioning effect of different welfare state regimes and to cluster the countries according to their stabilizing effect on the income distribution.