Niccolo Battistini, Giovanni Callegari & Luca Zavalloni: Dynamic Fiscal Limits & Monetary-Fiscal Policy Interactions

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November 9, 2018

Annual Workshop of the ESCB Research Cluster 2, Paris
Summary of the Paper

General Comments

Specific Comments

Conclusion
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Summary / Research Questions

- Calibrated DSGE model for EU-14, based on the model by Bi (2012) and extended with preference shocks

- How does the degree of monetary policy (MP) activeness affect fiscal sustainability?
  → MP shocks: more reactive MP raises the debt limit (up to 40% of GDP), reducing inefficiencies arising from inflation fluctuations.

- How is fiscal sustainability affected by persistent periods at the ZLB?
  → Negative aggregate demand shock: direct interest rate channel (↓ interest payments) and indirect growth channel (↓ tax revenue) move in opposite directions. At binding ZLB the growth channel prevails, worsening fiscal sustainability.

- How does the response of monetary policy affect the sustainability of government spending shocks?
  → At ZLB government spending shock may improve debt sustainability, with more responsive MP being better.
General Comments
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- Nice academic paper, well written, ready for submission to some journal.
- The results are calling for more **aggressive MP** to improve fiscal sustainability, but is it achievable in practice by the ECB or other central banks - implying higher interest rate hikes/cuts?
- Occasionally **binding ZLB** is not very relevant for fiscal sustainability, implying only negligible shifts in the fiscal limits.
- Some **policy conclusions** are surprising: escaping deflation (ZLB) by prescribing tax hikes as a remedy and further depressing output? At the ZLB government spending shock improves fiscal sustainability.
- Perhaps there are some issues with **calibration** of the model.
- Fiscal sustainability is usually associated with worsening **demographics**, this paper is not about that - would require different type of the model.
Specific Comments
Comments I: The model

- Rather simple fiscal policy in the model. Only labor taxes are considered. Consumption taxes? Interesting concept of fiscal devaluation, when the cuts in labor taxes are compensated with higher consumption taxes, might be studied for evolution of fiscal limits. Capital taxes? Adding capital in the model?

- Only exogenous government spending - no productive features (utility improving) or debt feedback (another fiscal rule).

- Lump-sum fiscal transfers: the concept of the minimum level of transfers politically feasible \( \underline{Z} \). Why is it introduced? Not clear what value is used.

- Discounting future maximum primary surpluses by political risk parameter \( \beta_p \). Should be better explained in the paper, e.g. reflecting the idea that policy makers have shorter planning horizons than the private sector. It seems that this parameter decreases fiscal limits in ad-hoc manner. What value is used for this parameter?
Comments II: Taxation

- What is steady-state value of labor tax $\tau$? What is reflected in its calibration - direct taxes, social contributions, something else?
- Maximizing tax rate 94%! is way too high (left picture). → Perhaps too low value for Frish elasticity of labor supply (0.42) is responsible for this result.
- Trabandt and Uhlig (2006) - maximizing labor tax rate for EU-15 around 60% (right picture).
Comments III: Minor issues

- Do positive and negative consumption preference shocks have same macroeconomic implications? Check description of the results.
- Interesting concept of forward-looking fiscal space index $SP_t^F$: perhaps it should be rather specified in absolute terms and normalised (with respect to the output/government budget) to be comparable across different tax and expenditure categories.
- Not clear what is meant by fiscal margin (red & yellow lines) in figures with different types of government spending shocks (no discussion in the text).
- Risk aversion $\gamma = 1$, so utility function should be logarithmic in consumption.
- Contractionary monetary policy shock is not shown in the figure, although it is mentioned in the text.
- Perhaps show also the effects of simple government consumption shocks on debt limit distributions.
Conclusion
Summary

- Promising paper, needs some polishing.
- The calibration of the model might be improved.
- Surprising policy conclusions should be supported by some other evidence/literature.
Thank you!
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