

Budget-Neutral Fiscal Rules Targeting Inflation Differentials

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The Paper in a Nutshell

Relevant and topical paper!

- A paper on using fiscal policy for economic stabilization
- A 2-country monetary union with inefficient fluctuations
- Central bank lacks ability to stabilize asymmetric shocks

Fiscal policy to the rescue

- Revenue-side policies that act upon inflation differentials
- Stabilization performance and welfare-effects

Distortionary taxes as stabilizers

- Variation in sales and labor income tax is welfare-improving

(In)efficient Fluctuations

Lack of stabilization benchmark

- What is the first best?
- Multiple (real) market imperfections and distortions.
- What is the second best?

Makes it harder to perform analysis of optimal simple rules

- Is proposed rule a good approximation of an optimum?
- Should we continue looking for better rules?

Relevant example: Lombardo and Ravenna (2014)

- Start with a simpler model...
- ... and then move to a richer model.

Policy Instruments

Distortionary fiscal instruments are powerful (Farhi et al (2014))

- Consumption tax affects consumption demand
- Labor income tax affects labor supply

The role of labor income tax deserves more discussion

- Changing consumption tax rule affects dynamics of labor tax
- Is it important for the results? Likely, yes.
- Easy to check by imposing lump-sum taxes instead

Foreign policy has spillovers to domestic economy

- Foreign consumption tax affects demand for domestic tradables.
- Foreign country follows a symmetric rule.

The role of consumption tax in the foreign country

- Symmetric tax rules compensate for inability to charge different tax on consumption of tradables and nontradables.
- By design, consumption taxes move in the opposite directions.
- Domestic tax cut stimulates demand for both goods.
- Foreign tax increase contracts demand for domestic tradables.

Policy Targets

Inflation differentials as policy targets

- To what extent is it optimal to stabilize inflation differentials?
- Is this a welfare-relevant economic indicator?

Other policy targets

- Existing research: gains from reacting to terms of trade
- Inflation differential is a composition of terms of trade
- Is reacting to inflation differential superior?

Other comments

Explaining welfare losses in mean consumption

- Relies on existence of price dispersion.
- Displaying stats for dispersion could support explanation.
- How do dispersions in tradables or nontradables compare?

Calibrating government spending

- Duarte and Wolman (2008): both nontradables and tradables
- Here:
 - only nontradables;
 - larger steady-state spending ;
 - same stochastic properties.