COMMENTS ON SESSION 4
FISCAL TOOLS TO CONTROL MACROECONOMIC RISKS AND IMBALANCES: EXPERIENCES AND PRESCRIPTIONS

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I would like to thank Daniele Franco and Banca d'Italia for inviting me to participate at another great Public Finance Research Workshop in Perugia. My comments today are going to be primarily directed to the two papers that were assigned to me, with the usual disclaimer that the views expressed are my own. Both papers are well written and I thoroughly enjoyed reading them. The authors also provide a very good literature review along with their insightful discussions.

It is interesting to note the similarities – the papers cover small economies with floating exchange rates and focus on macroeconomic policy imbalances. Both these papers point to a good record of fiscal management due to transparency-based framework for encouraging responsible fiscal policy management, as set in the Public Finance Act (New Zealand) and the Fiscal Responsibility Act (Mexico). On the other hand, the dissimilarities are that the Mexico paper deals with the issue of oil price setting while the New Zealand paper focuses on increasing the county's private savings rate. I will briefly comment on the first paper by Brook and then move on to the second paper by Aguilar and Ramírez.

Comments on "Macroeconomic Imbalances and Fiscal Policy in New Zealand" by Anne-Marie Brook

The paper by Brook discusses the role that fiscal policy in New Zealand may have played in contributing to its macro-economic imbalances, including a very negative net international investment position, with large current account deficits, a significant build-up of household debt linked to strong house price increases, a persistently over valued exchange rate and a productivity level lower than average reported for wealthier economies. As mentioned in the paper, the above trends are somewhat puzzling given New Zealand's generally sound fiscal framework and attractive business environment.

The paper examines the role of fiscal policy that may have contributed to persisting these imbalances and the persistent shortfall of national savings relative to investment. The author's view is that the existing macroeconomic imbalances pre-date the episode of pro-cyclical fiscal policy identified and discussed in Sections 1 through 5 in the paper, as such the stabilization role of fiscal policy is not likely to play a major role as part of solutions in dealing with the country's macroeconomic imbalances. Changes to the Public Finance Act currently underway are expected to put more emphasis on the importance of fiscal policy stabilization in future economic upturns, although political challenges to ensuring that surpluses are not "spent" (either on "tax cuts" or spending increases) is likely to persist, as reflected by the author. Brook is somewhat skeptical that more stabilizing will do much more to affect New Zealand's macroeconomic imbalances.

Interestingly, Brook suggests that the more microeconomic aspects of fiscal policy, particularly, the *structure role* of fiscal policy, such as tax policy and retirement income policy may be playing a more important role and not fiscal sustainability, as is generally the case with many OECD countries, in putting undue pressure on macroeconomic imbalances.

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The views expressed are those of the discussant and does not necessarily reflect the views of the New Jersey Department of Treasury, New Jersey State or the National Tax Association.

The paper employs the three dimensions of good fiscal policy, which include sustainability, stabilization, and structure as key components. In particular, the paper focuses on the low private savings rate and examines the extent to which changes in fiscal policy structure may have potential to boost private saving, and thus alleviate macroeconomic imbalances.

The paper discusses how the tax system influences savings, including: (i) inter-temporal distribution, and (ii) distribution of savings across different savings instruments. There is a good discussion on how the choices of a comprehensive tax base has important implications on the impact on savings, even though, the empirical evidence on the impact of tax incentives on savings is mixed. New Zealand's experience with non-neutrality among different saving instruments was noted and some have argued that the tax-favored nature of the ownership of housing has led to too much of the country's savings being diverted into housing and the resulting problems.

Different measures to potentially raise savings rate and improve the composition of savings is laid out in Sections 5.1 and 5.2 along with a discussion of the quantification results and underlying trade-offs. Under one of the options suggested, the tax rate on capital income would be reduced by extending the existing PIE regime, along with other changes such as a capital gains tax so as to mitigate the equity and revenue impacts. Another measure suggested by Brook would be to move toward a private save-as-you-go (SAYGO) pension system, which would involve pairing compulsory savings with means-testing of New Zealand's universal old-age pension (NZS).

I would like to conclude with the following open questions and some thoughts on extending the analysis on New Zealand: What happens when the underlying income distribution is taken into account? How would differences in degrees of propensity to save across different income/population cohort affect the outcomes under proposed solution options? In this context, a much detailed evaluation of underlying distributive implications of different tax favored savings schemes would be insightful for the policy maker. It would be useful to examine the dynamics of the fiscal policy structure component under alternative scenarios such as different inflationary environments.

The role of Rainy Day Fund and enforcement issues are additional potential areas for future research. The leveraging process of households and agricultural sectors probably should be looked at and the importance of cultural variables and institutions (such as faith and thriftiness factors) in enhancing private savings rate may merit due consideration as well. I also concur with Brook's observation that the paper would benefit by extending its focus on other policy areas that may have impacted macroeconomic imbalances such as economic regulation and competition policy.

Overall, the thrust on the more microeconomic aspects of fiscal policy (the *structure role* of fiscal policy) in supporting external balance by encouraging a higher rate of private saving is interesting. However, till we have a clear track history, it will be difficult to know the actual impact of the proposed changes and policy options suggested in this paper. The final results would also be a function of when and how the Parliament acts on the pending measures under the Public Finance (Fiscal Responsibility) Amendment Bill – so stay tuned.

Comments on "Oil-dependent Revenues and Macroeconomic Stability Under Fiscal and Monetary Rules: An Analysis of Mexico" by Ana María Aguilar and Claudia Ramírez Bulos

The paper by Aguilar and Ramírez discusses challenges of the highly oil-dependent public finances in Mexico, the setting of oil prices by a set of government rules and issues with macroeconomic stability. They examine this fiscal situation and its interaction with the monetary policy to assess the appropriateness of Mexico's energy pricing rule in the new oil price environment.

The authors develop a small open economy macroeconomic model to analyze the effect of oil prices on Mexican public finances. Assuming monetary policy follows an optimal rule, the paper evaluates the impact of two different fiscal policy rules: a balanced budget rule or a structural balance rule and finds that when the economy faces inflation or consumption shocks, both rules generate almost the same effect. However, the authors note that when oil price shocks occur, higher macroeconomic stability is achieved and the monetary authority reacts less aggressively under the structural balance-budget rule.

The paper assumes that non-core inflation, oil price gap, etc. follow an AR (1) process. Here the question that comes to mind is what happens if this assumption is changed? That is, if the AR (1) process is not followed by the variables under consideration?

Several positive developments are mentioned to have taken place, such as greater transparency and accountability and policy decisions being made under a *regulatory* framework rather than a *discretionary* one. These reforms have helped but as the authors correctly note that Mexican public finances still remain vulnerable.

It appears that the central bank has been very successful in addressing supply shocks to inflation on account of exchange rate fluctuations and volatility in agricultural prices. However, the Mexican economy appears to not have learned to absorb energy price volatility in an orderly manner, leaving it as an open issue.

The discussion of the history of oil price development was quite informative. However, the modeling framework needs to be enhanced by making the mechanics of oil price change more explicit, indicating whether it is supply-driven or demand-driven. The effect on oil prices from the risk of future supply constraints or the expectation of future economic growth should also be included. In a recent analysis using a partial least squares (PLS) technique,[1] the 1990s were identified as a period of excess supply in the oil market, and the 2000-09 period as one in which demand factors were dominant. The oil price volatility during the Great Recession was attributed to the rapidly changing expectations about demand. More recently, according to this analysis, supply pressures have appeared again as major oil-price determinant.

I would like to conclude my discussion of the paper on Mexico with a few questions to the authors and suggestions for possible extensions of their study. For instance, what are the implications of alternative model specifications to deal with an abrupt adjustment of exchange rates? What happens when the assumption of equal weights is changed in the case of interest rate smoothing process? It would be useful to discuss the underlying adjustment process in greater detail to reflect on lags and other secondary effects, including a discussion of underlying regressivity implications.

An analysis of the disbursement side indicating how the oil revenues are allocated among different tiers of government, what programs are covered, whether or not the spending components are earmarked with oil revenues or funded as part of general fund oil revenues, could make a difference to final policy outcomes depending on whether there is budgetary flexibility or rigidity. Finally, the policy trade-offs and distributional implications under proposed changes need to be highlighted and discussed fully.

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1 For details about the Federal Reserve Bank of New York analysis see the blog on "A New Approach for Identifying Demand and Supply Shocks in the Oil Market" posted at: http://libertystreeteconomics.newyorkfed.org/2013/03/a-new-approach-for-identifying-demand-and-supply-shocks-in-the-oil-market.html