COMMENTS ON SESSION 1
FISCAL STABILISATION

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I would like to thank Daniele Franco and Banca d'Italia for inviting me to participate at another great research Workshop on Public Finance in Perugia. He is to be congratulated for his choice of relevant topics dealing with important public finance policy issues for the 9th consecutive year! I have been assigned to primarily discuss the papers by Hasko and by Robbins, Torgunrud and Matier. Time permitting, I will also try to provide some comments on the paper by Hassan. I'll conclude my comments with some thoughts for future research. The papers cover important but different fiscal policy grounds. The first two papers, in particular, present good literature reviews, which I found very helpful.

1 "Public Debt Dynamics in Selected OECD Countries: The Role of Fiscal Stabilisation and Monetary Policy" by Harri Hasko

Using a basic recursive, reduced form VAR model, the paper tries to find out if the response of fiscal policy to unforeseen economic shocks has been stabilizing and the relative significance of different causal factors in the context of debt dynamics. The paper provides a good analysis of the results of the impulse response functions and variance decompositions to determine how the different types of shocks may have impacted the public debt dynamics.

One of the major conclusions of the Hasko paper is that shocks to economic growth and monetary and fiscal policies have played a major role in public debt developments since the mid-1970s. It would be interesting to investigate if the results of the analysis would change if "output gap" is used instead of "output growth"? Conducting a sensitivity analysis to show how sensitive the results are to the underlying specification and modifications used would be a useful exercise.

The paper reports that on average, shocks to output growth and inflation are less persistent than policy shocks but there is some ambiguity as to why that is the case. In general explaining the major results in clear, and perhaps non-technical, terms would make the analysis more useful to policy makers. Some additional discussion of the results presented in Section 4 would also improve the clarity of underlying findings. For instance, pointing out why or why not the share of revenue is larger than expenditure in the three countries with peculiar debt histories (Finland, UK and Japan) and in Canada while shocks to public expenditure have the largest

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share in the variance decomposition in Germany, Greece and Austria. Also indicating how these factors vary by specific country attributes would be helpful.

Examining how the underlying fiscal federal structures affect the debt dynamics in the various countries would be an interesting extension of the paper. One way to highlight country specific differences may be to include an appendix showing major economic indicators along with fiscal and monetary trends for defined periods of time.

The paper shows that "unexpected shocks" to monetary and fiscal policy have played an important role in the developments of public debt in the sample countries. One potential extension of the analysis would be to examine how the public debt dynamics would be affected on account of "expected or anticipated shocks" to the system – growth in pension and heath care cost due to changes in the demographic profile of the population, changes in federal mandates, court-decision related changes etc.

A very important and useful conclusion that emerges from the paper is that shocks to expenditures have larger share in the variance decomposition which is in line with the common finding that "fiscal consolidation measures that seek to restrain expenditure developments are more efficient than actions in the revenue side". This is particularly meaningful, certainly in the US context, given the growing resistance to new taxes and the limited room to increase tax rates.

The paper should include some discussion on why only 40 percent of the thirty OECD countries were chosen in the sample? It may be useful to extend the analysis to other member countries since fiscal imbalance or public debt management is a serious policy concern in most countries.

Another extension would be to consider the role of accounting practices such as the treatment of transfer funds in the context of public debt dynamics. The way the US Social Security trust fund for the Old Age and Survivors Insurance (OASI) account, for instance, is treated accounts for the gap between reported federal deficit and change in total public debt.[1]

2 "Fiscal Planning under Uncertainty – The Implications of Economic and Fiscal Uncertainty for Budget Forecasts" by Jenna Robbins, Brian Torgunrud and Chris Matier

This paper analyses the uncertainty in projections of the federal budget balance arising due to uncertainty in economic, and government revenue and spending projections. Using a stochastic simulation model (SSM), the paper presents estimates of the impact of forecast uncertainty on federal budget projections in Canada. The paper provides a good literature review on previous applications of the

[1] For a more detailed discussion refer to Pakko, M. (2006), "National Economic Trends", Federal Reserve Bank of St. Louis.

SSM before laying out its own model specification. The Appendix section contains very useful information, particularly, it clearly lays out the federal fiscal forecasting process and timeline in Canada.

A striking result indicated in the paper is the $13.2B in federal surplus for FY06, which was the ninth consecutive year that federal revenues exceeded federal program spending since FY98! The paper should include some information on the Canadian experience with budget deficits in the years prior to the period under consideration and its current public debt situation such as debt level as percent of GDP. It should also include some discussion on the move to surplus targeting following the consolidation of fiscal finances from the deficit targets of the mid-1990s.

Deliberating on what should be the size of the minimum surplus would be useful. Various probabilities are indicated but the desired level is left open to the discretion of the policy maker. It would be helpful to indicate as to which level of surplus would support long term fiscal balance. The paper should also consider including some discussion on what portion of the planning surplus should be left unallocated to address the issue of forecast uncertainty. I would suggest elaborating on the mechanics of how the effects of forecast uncertainty can be mitigated by changing the allocation of the planning surplus to new tax and expenditure measures.

The methodology used in the paper to avoid additional volatility in revenue estimates due to tax policy changes by considering the federal finance department's historical forecast record rather than the historical series for realized federal revenues makes a lot of sense, as supported by the improved results on standard errors. In New Jersey, the baseline growth rate is used to make revenue projections for the out years with adjustment for policy changes.

In Section 4, model results are discussed based on descriptive statistics for key economic variables over the planning horizon FY08 to FY12. Unlike the presentation of the results for real and nominal GDP variables, the interpretation of GDP inflation results are not clear from the numbers posted in Table 2. Also Table 4, which discusses the range of possible outcomes for fiscal variables, shows that the underlying budgetary balance remains positive, ranging from $7.2B to $13.2B or 2.6 percent (FY09) to 4.8 percent (FY12). It is not clear why the results are showing negative budgetary balances for the 5^{th} percentile, which is also consistently growing over the forecast period?

Another point of clarification pertains to why the public debt charges remain at a constant level of $34B+ with the median forecast for public debt charges assumed to go down by $3B in federal debt reduction per year? In general, the results are discussed in terms of median budgetary revenues and spending forecasts. How do they compare with average forecast values?

An important inference noted in the paper is that a certain degree of uncertainty is unavoidable no matter how sophisticated the forecasting process. After all forecasting is not yet an exact science and who can predict the role of the

invisible hand in the economic arena! In fact the suggestion about targeting a minimum surplus to guard against negative shocks to the fiscal forecasts or the role of rainy day fund is a useful measure for fiscal planning under uncertainty. In the U.S. the policies with regard to rainy day fund varies across states. In general, 50 percent of the amount by which actual revenues exceed anticipated revenues is transferred to a surplus revenue fund in New Jersey with a cap set at 5 percent of anticipated revenues.

It would be useful to include some discussion about limitations with using historical trends in the forecasting process – how are extraordinary years treated, e.g., the post-equity bubble period, or government amnesty programs (Canadian experience)? Major changes in tax or expenditure policies? Extending Table 9 of the Appendix to layout major policy changes and economic trends in these years and indicating any major data revisions would also be helpful.

In this paper the focus of fiscal planning centers on uncertainty in the forecasting process, the efficiency of which can be improved by lowering the associated standard errors through improvements in the quality of forecast data and with improved forecast methodologies. I would suggest extending the analysis to discuss other areas of addressing fiscal planning under fiscal uncertainty. For instance, checking if the existing revenue sources are keeping pace with changing economic trends. Is the current tax base capturing say e-commerce? In the US, several states are attempting to extend their sales tax base to services and remote sales. Tax avoidance under the corporation business tax is another case in point, which adds uncertainty to the forecasting process.

3 "Procyclicality, Fiscal Dominance, and the Effectiveness of Fiscal Policy in Egypt" by Mohamed Hassan

Hassan's paper on the fiscal policy experience in Egypt, based on a structural vector autoregressive (SVAR) model, indicates that the relationship between fiscal policy and economic activity is weak. The paper provides a good overview of fiscal accounts in Egypt in the last twenty four years since the eighties and suggests that fiscal policy is procyclical and mainly discretionary.

The paper explains this in terms of certain characteristics in the Egyptian system (large share of wages and interest payments), which limit the ability of conducting counter cyclical fiscal policy.

Some detailed description of the expenditure composition would be helpful in understanding the policy dynamics in the Egyptian context. For instance, what is in the "other" component that accounted for over fifty percent of total share in 2005? Also, it is not clear why the share of subsidies declined by nearly half from 15 percent in 80/81 to 7.7 percent in 04/05?

One suggestion for future work would be to do a comparative analysis using the OECD experience. Another alternative may be to focus on similar economies or

countries with similar fiscal systems and then compare their results with those for Egypt. As noted in the paper, that differences in the infrastructure base explain why developed countries can use fiscal policy for countercyclical purposes relatively successfully.

Given globalization, economic events and business cycles in one country would affect others. It would be useful to explore the implications of recognizing this factor explicitly and attempt to identify how Egypt's deficit situation has been affected by recent regional trends.

I would like to conclude by pointing out that it is important to (i) identify all the pieces of the puzzle both on the revenue side and the expenditure side; and (ii) distinguish between cyclical and structural deficits. In particular, it is important to recognize the realities of today – all most everywhere the demographic developments are expected to put heavy pressure on public finances mostly in the form of increasing pension and health care costs. Retirees for instance are living longer. These trends are contributing to serious problems resulting from fiscal imbalances and rising public debt. Facing these challenges, would require all countries, OECD and others, to manage their fiscal stabilization policies efficiently and to ensure the soundness of their public finances both in the short and long run.