# Comments on:

## The Identification of Fiscal and Monetary Policy in a Structural VAR by Mardi Dungey and Renée Fry

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- "... *effective economic management depends on understanding the nature of shocks hitting the economy* ...," DF(2008,p1)... **demand management argument**.

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- *"...the influence of the fiscal policy stance on output has sometimes been substantial, and generally outweights the contribution of monetary policy shocks,"* DF (2008, abstract).

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- "...*the influence of the fiscal policy stance on output has sometimes been substantial, and generally outweights the contribution of monetary policy shocks*," DF (2008, abstract).
- **My interpretation:**
  Fiscal policy was the major cause why output deviated from its "long-run" trend in New Zealand... **is it good or bad?**

# I like about the paper...

The identification methodology is very neat, and I believe it is potentially powerful.

# Being advocatus diaboli...

I am not sure whether

- the methodology is coherent with the paper's motivation (**what is the logic of policy shocks?**)

# Being advocatus diaboli...

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- the methodology is coherent with the paper's motivation
  (**what is the logic of policy shocks?**)
- Mardi and Renée use their methodology to get a buyable summative model
  (**fiscal policy does not have permanent effects**)

# Demand vs. supply side management

"... **There are important gains in welfare from better fiscal policy, but ... these are gains from providing people with better incentives to work and to save, not from better fine tuning of spending flows**," Lucas (AEA Presidential address, 2003, p1).

# Welfare gains from eliminating consumption fluctuations

Borrowing the example from Lucas (2003)

**Example**

Under policy A the consumer's welfare is $U(c_A)$. Under policy B it is $U(c_B)$. Suppose that she prefers $c_B$: $U(c_A) < U(c_B)$. Let $\lambda > 0$ solve

$$U((1+\lambda)c_A) = U(c_B)$$

For a stochastic case

$$\lambda = \frac{1}{2}\gamma\sigma^2$$

$\gamma$ is risk aversion parameter, $\sigma^2$ volatility in consumption.

# Welfare gains from eliminating consumption fluctuations

**New Zealand:** $\sigma$ is 0.0267. I set $\gamma = 5$. Then

$$\lambda = \frac{1}{2}5(0.0267)^2 = 0.0018$$

# Welfare gains from reducing the revenue tax:

Firm's revenue tax in the Ramsey growth model

## Example

The steady state level of capital and consumption are given by

$$\hat{k}^* = \left\{ \frac{1}{\alpha} \left[ \frac{\rho + \theta x}{1 - \tau_f} + \delta \right] \right\}^{\frac{1}{\alpha - 1}}$$

$$\hat{c}^* = \hat{k}^{*\alpha} - (x + n + \delta)\hat{k}^*$$

Lets examine the effect of changing $\tau_f$.

# Welfare gains from reducing the revenue tax:

**New Zealand:**
10 % reduction in revenue tax yields about an 8% increase in consumption.

# Back to Mardi and Renée's paper

Not a buyable summative model because …

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# Back to Mardi and Renée's paper

Not a buyable summative model because ...

- covers only demand side issues
  *(look at the economic reforms in the 80's)*
- fiscal policy should be allowed to have permanent effect
  *(estimated effects of FP are strong (in comparison to MP) but still not as strong as we may observe in reality)*