

Discussion of O. Blanchard

Fiscal policy as a stabilization tool. The case for quasi-automatic stabilizers

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Monetary-Fiscal policy mix: stark separation?

- Not in **theory**.(HANK models)
- In practice → Stark separation between MP and FP: stabilization vs redistribution.

Why stark separation?

1. Implementation lags
2. Political decision lags
3. Debt bias (preference for the present)

⇒ **VAT** quasi-automatic **stabilizer** good candidate

VAT as a stabilization tool: why yes

VAT as stabilization tool: why yes

1. In EU, VAT accounts for **30 percent** of total tax revenue, or **12 percent** of GDP.
2. Very **direct** measure \Rightarrow Households have to **buy something** in order to fully benefit from the policy, in contrast to **transfers** which can be **saved**
3. Instrument of **unconventional FP** at the ELB \Rightarrow Contrast to unconventional MP which relies on consumer **sophistication** (e.g., forward guidance)

\Rightarrow Consumption taxes can replicate **negative real interest rates** and offset ELB.

4. **Salience** of VAT changes arguably superior to **real rate** changes

Expectations and agents' sophistication

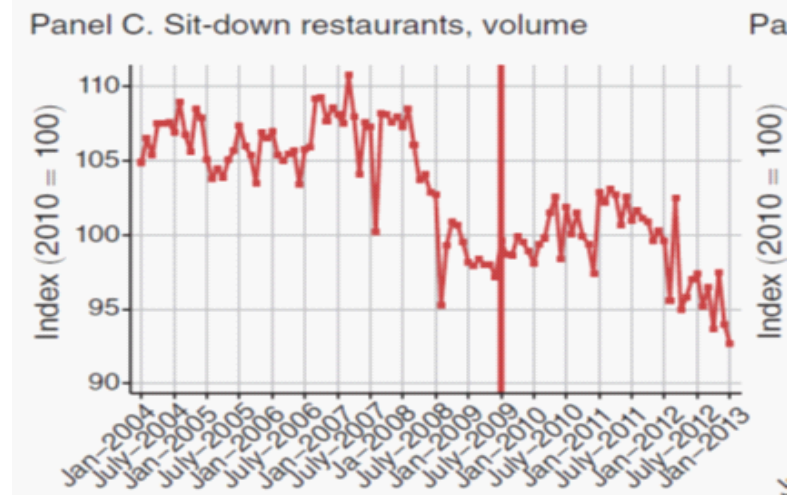
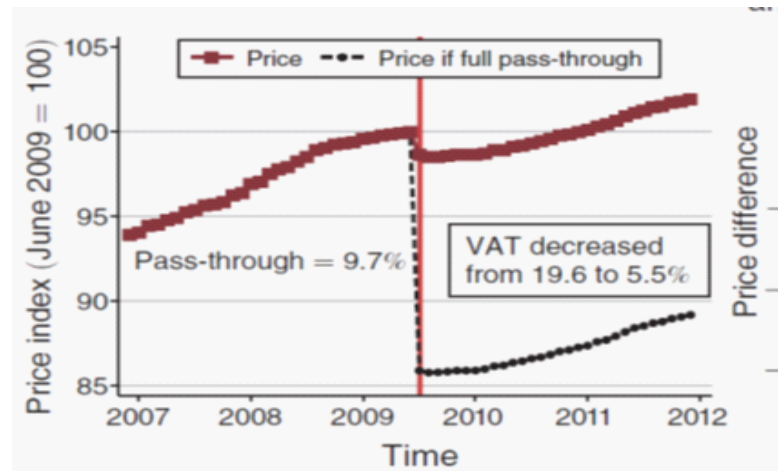
- Assume agents are **k-level thinkers** (Bianchi-Vimercati, Eichenbaum, Guerrei 2023)
- Higher **government spending** \Rightarrow GE effects: increased labor demand and higher labor income \Rightarrow Increase in consumer demand.
- The less sophisticated people are, the less they take into account the positive GE effects of higher spending. Lower levels of cognitive sophistication imply lower values for the **G multiplier**.

- **Tax (VAT) policy** relies on individual **intertemporal substitution**. Basic force is operative **regardless** of any GE considerations, i.e., people do not need to calculate the GE effects of tax rate to adjust their personal consumption decision.
- Tax policy can boost consumption demand and **support the flexible-price allocation** when the ZLB binds, even if people are very unsophisticated.

VAT as a stabilization tool: why not

The cons of VAT as stabilization tool

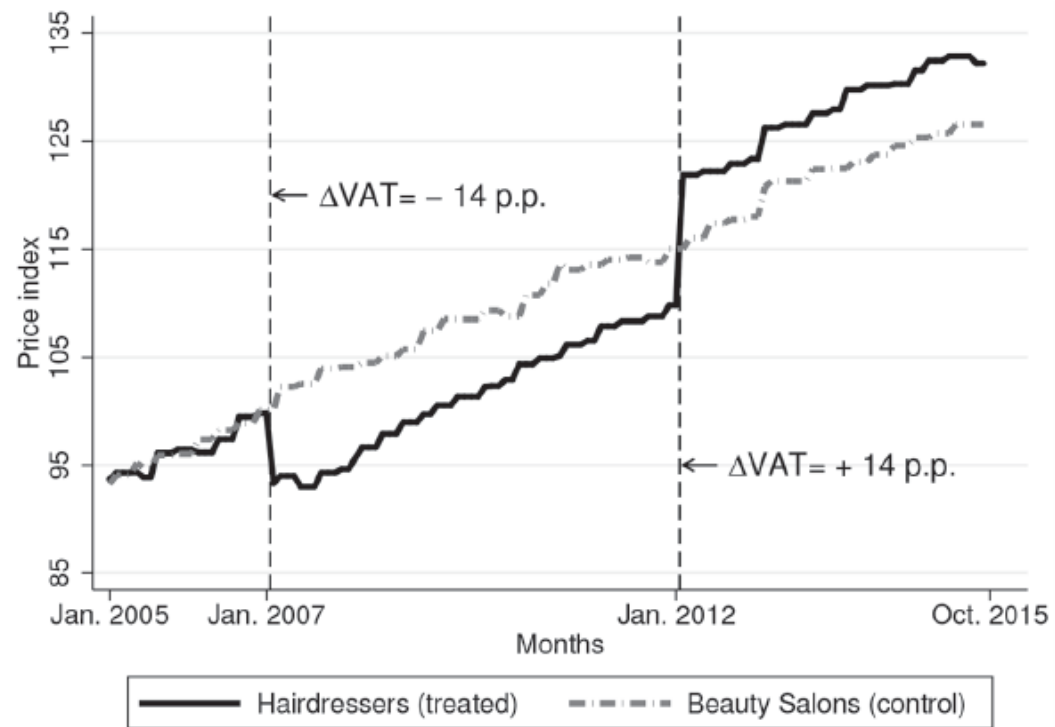
- Ability of VAT policy to stimulate spending depends on **price pass-through**. Evidence on pass-through is very mixed
- If pass-through is **limited** then most of VAT change reflected in **markups**.
- Example. In July 2009, VAT rate for **meals** consumed in French sit-down restaurants was reduced from 19.6 percent to 5.5 percent. Limited effect on **prices** and **employment**. Large effect on **markups/profits**
- Large **distributional** effects. In the long run firm owners pocketed around **55.7 percent** of the VAT cut, consumers received the remaining **13.6 percent**. (Benzarti et al 2019)



Change in VAT rate for meals consumed in French sit-down restaurants

Asymmetric price effects

- **Asymmetry** significant property of VAT changes.
- Similar to **interest rate** changes
- Prices respond significantly more strongly to **increases** than to decreases in VAT



Finnish hairdresser salons VAT change.

Asymmetric price effects (con't)

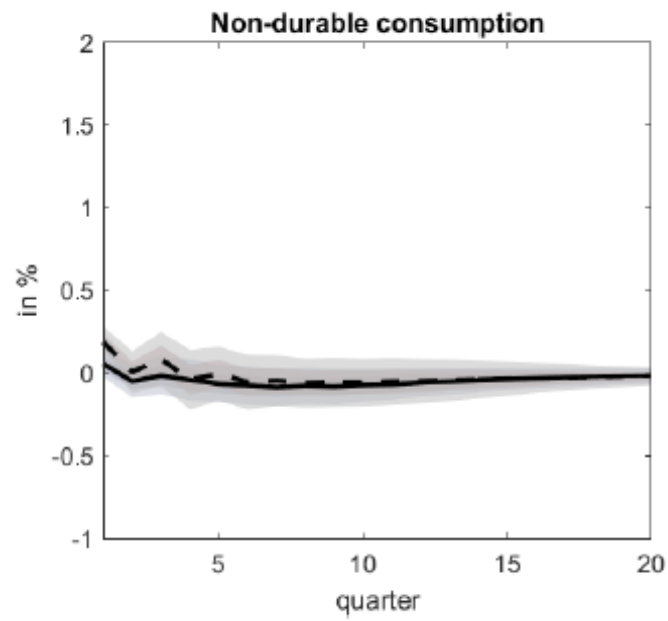
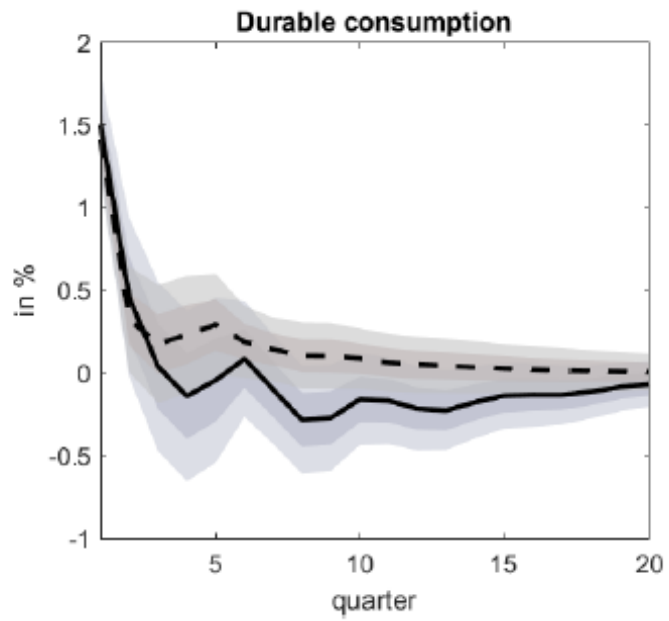
- **Pass-through estimates** used to inform policy typically do not differentiate between VAT **increases** and **decreases** \Rightarrow Likely to severely **overstate** the price effects of VAT decreases and understate the effects of increases.
- Failing to account for the asymmetry can lead to overestimates of the pass-through of VAT decreases by a **factor of 3** (Benzarti et al 2019).
- Temporary **VAT cuts** may have **unintended effect** \Rightarrow In long run can lead to **higher** equilibrium prices once the VAT cut is repealed, benefiting **firm owners** at the expense of consumers.

A VAT Tax rule?

- VAT tax rate set as a function of the output gap / unemployment gap.
- This form of communication substantially **degrades the efficacy** of tax rate policy.
- When VAT policy communicated as a **rule**, individuals must forecast the **future** level of output / unemployment to predict what **tax rates** will be.
- If individuals are **limited** in their ability to compute GE effects, they will also be limited in their **ability to forecast** future tax rates.
- Translates into a **lower efficacy** of tax policy in stimulating demand.

Selective effect on durables

- **SVAR** with [GDP, Consumption, VAT tax rate] + Blanchard-Perotti identification
- Large effect on **durables**
- Akin to **interest rate** changes (intertemporal substitution effect)
- Selective effect on expenditure but effective at ELB



Responses of D and ND consumption to a 1% change in VAT (SVAR estimates)

State-contingency of VAT changes

- A suitable stabilization tool should work **better in recessions** rather than expansions
- Recessions are periods of (i) heightened **uncertainty** and (ii) tightening **credit constraints**
- Durable spending has an irreversibility (lock-in effect) \Rightarrow With uncertainty, irreversibility is more costly
- Constrained agents may choose to **reduce debt** rather than bring spending forward

⇒ Paradox: VAT changes **less effective** in recessions?

Conclusions

- Provocative paper
- Role of fiscal policy as stabilization tool more prominent in **theory** than in practice
- VAT **rule** requires agents' **sophistication**
- Effects of VAT changes depend on **price pass-through** and are typically **asymmetric**
- VAT isomorphic to interest rate changes: more salient but impacts **durable** spending selectively