Discussion
Fiscal Policy and the Distribution of Consumption Risk
by Croce, Nguyen, and Schmid

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Summary of the Paper

- Bansal and Yaron meet Romer + Labor Tax

- Countercyclical fiscal policy combined with endogenous long-run risk increase welfare cost
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Outline

1. Model
2. Fiscal policy
3. Calibration
The Model

- Household: Epstein-Zin preferences with elastic labor

- Endogenous growth (Romer 1990)

\[
\text{Growth } \approx f(\text{market value of future profits}) = f(\text{discount rate, labor})
\]

1. cash flow channel (profit)
2. discount rate channel

- Fiscal policy: smooth labor through tax and government debt
The Mechanism

1. Intertemporal substitution between labor tax and government debt

\[
\begin{align*}
\{ \text{govern expenditure} & \uparrow \\
\text{productivity} & \downarrow \} & \implies \{ \text{labor tax} & \downarrow \\
\text{public debt} & \uparrow \} & \implies \{ \text{long-run profit} & \downarrow \}
\end{align*}
\]
The Mechanism

2. **New:** Intertemporal substitution between short-run and long-run consumption risks

\[
\{\text{smoothing labor}\} \implies \left\{ \begin{array}{l}
\text{short-run risk} \downarrow \\
\text{long-run risk} \uparrow
\end{array} \right\}
\]

\[
\implies \left\{ \begin{array}{l}
\text{market value of future profits} \downarrow \\
\text{growth} \downarrow
\end{array} \right\} \implies \text{higher welfare costs}
\]
Fiscal Policy

Countercyclical fiscal policy = *procyclical* labor tax + countercyclical debt

- Is the *procyclical* labor tax here Ramsey optimal?
  - Ramsey problem: Smooth taxes
  - This model: Smooth labor

- Ramsey optimal labor tax in *exogenous* growth model - constant
  - What happens if tax is constant - tax smoothing?
  - Weaker result on welfare cost?

- Ramsey optimal labor tax in *endogenous* growth model with time–separable preferences - *zero*

- This model: continuation value in Epstein-Zin preferences may matter for optimal tax
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Calibration

Labor market statistics are missing

- Volatility of labor (hours) and wage rate
  - Procyclical tax may imply too smooth hours and too volatile wage

- Volatility and cyclicality of government debt

\[ \frac{B^G_t}{Y_t} = \rho \frac{B^G_{t-1}}{Y_{t-1}} + \epsilon_{B,t} \]
\[ \epsilon_{B,t} = \phi_B (\log L_{SS} - \log L_t) \]

Calibrate \( \phi_B \) to match the debt dynamics

- Is debt-GDP ratio stationary?
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Quantity of Risk

- Long-run risk only picks up price of risk. What happens if we match quantity of risk?

- Needs sticky wages (Favilukis and Lin 2012)
  - the discount rate channel will be strengthened
  - the issue of volatility of hours/wages would be mitigated
  - even larger welfare cost?
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Very interesting paper!

Would be nice to see fiscal policy connected to Ramsey optimal tax