

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

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The main issue: short versus long run focus of fiscal policy

- “Fiscal austerity debate”: excessive fiscal consolidation (may) kill current recovery, but should help long-run sustainability
- “Fiscal stimulus debate”: stimulus (may) improve current conditions, but at the expense of debt buildup, necessitating future consolidation
- Can we think about such tensions in a unified and quantitative framework?
 - This paper is a very good example of this

The “first guess” channels

- Higher risk discourages investment
- Increased precautionary savings by households
- Increased savings to meet future tax liabilities (Ricardian equivalence)
- A quote from Rajan, 2011 (The Guardian): “[...] The conservative economist responds that it is precisely because the government has become so free with taxpayers’ money that households, fearful of future taxes, are hunkering down and increasing savings. Moreover, the increasingly activist government has left businesses uneasy about future regulatory and tax measures, and thus reluctant to invest.”

The story here is very different

- Epstein-Zin preferences, introducing a separation of short-run versus long-run consumption risk (and hence stabilization)
- Combined with an R&D based endogenous growth model, ...
 - ... where profit risk and endogenous labor supply further exacerbate the short versus long run stabilization tradeoff
- The policy tradeoff can be labeled as “employment versus investment stabilization”
- Is this the “policy relevant” story/mechanism?

Main ingredients of the paper

- Households:
 - Epstein-Zin preferences, being averse to both short- and long-run uncertainty
 - Supplying labor elastically
- Firms:
 - The usual ingredients plus an R&D sector, leading to endogenous growth
 - The impact of taxes on the endogenous growth rate is very complex
- The government
 - Exogenous and fluctuating expenditures (can be relaxed)
 - Tax rules:
 - Zero deficit
 - Short-run stabilization (targeting employment): strength and persistence of the fiscal reaction
 - Long-run stabilization (targeting aggregate profits/stock market index): similar two parameters

Main results of the paper

- Short-run stabilization is welfare improving under CRRA
- But it is (can be) welfare reducing under the “benchmark EZ calibration”
 - This is the outcome of a positive effect of lower short-run but higher long-run risk/volatility
 - The welfare loss is quantitatively relevant (1-4% of lifetime consumption)
- Long-run stabilization is (can be) welfare improving
 - As an outcome of a similar tradeoff than before
 - Quantitatively meaningful (1-2%)
- Fiscal policy can influence the term structure of profit returns
- IES plays a central role, as $\gamma - 1/\psi$ controls the strength of the “EZ channel”

- Differentiating capital and labor owners
 - The aggregate gains might be distributed in a socially undesirable way
 - Or at least it might clash with “political economy considerations”
- How does the level of taxation (or “the government” in general) impact the average growth rate?
 - The paper concentrates on the impact of the timing of taxation on the growth rate
 - Would be good to see how much taxes matter here overall

- Optimal policy?
 - Admittedly very difficult
 - As long as there is a tradeoff between short- and long-run volatilities, the optimum will depend on (and hence will be sensitive to) model parameters and ingredients
 - Mankiw et al, 2009, JEP: “Lesson 8: In stochastic dynamic economies, optimal tax policy requires increased sophistication”...
- Governments seem to be occupied with short-run stabilization/objectives in general
 - How large/immediate is the growth effect of stabilization policies?
 - Are they visible? Can governments ever “claim victory”?
 - Should we model/understand their behavior better or should they understand/implement our results more?

- A very complicated framework, though the structure is “almost minimum necessary” in most aspects
- R&D production is not totally exogenous, but it is not fully modeled/microfounded either
 - In particular, it does not require labor as a direct input (like in the classical Grossman-Helpman frameworks)
 - Would that matter?
- Multiplying leisure with the number of intermediates to ensure balanced growth: seems to be a technical assumption but could be discussed a bit more

The role of preference parameters

- The size of the IES is crucial
 - There is very little quantitative action for ψ being below unity, and welfare losses start increasing very steeply at around 2
 - Repeat the IES robustness exercise (section 4.3) for the long-run stabilization case (section 5)
 - Relate macro-based calibration to micro-based estimates
- Labor supply elasticity
 - What is the implied tax price elasticity of labor supply?
 - The calibration assumes a Frisch elasticity of 0.7
 - Chetty et al (2012): the consensus micro-based estimate is around 0.5 – would that matter?
 - Is it a Frisch elasticity (driving labor supply reactions at the business cycle frequency) or a Hicks elasticity (driving long-run responses) that matters?
 - The latter is even smaller (around 0.3)
 - In short: would like to see whether this elasticity matters

- A very cool and important paper, a hard but very rewarding read
- Quantifies a highly relevant tradeoff between short-run and long-run fiscal stabilization
 - Maybe not the most immediate (and policy relevant) channel one would have expected
 - But the ingredients, their working and impact are clearly described
- Would be good to see some more on the role of the IES and labor supply elasticities
- A general lesson: assessing the empirical relevance of EZ preferences is of first order importance for dynamic (stabilization) policies