

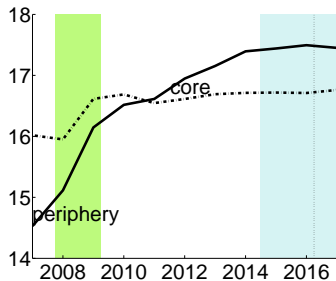
Discussion of McKay and Reis:
Optimal Automatic Stabilizers

Keith Kuester, University of Bonn

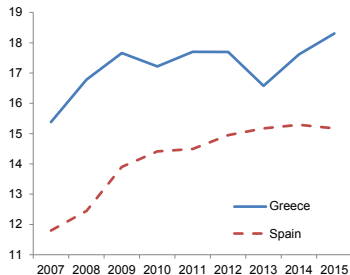
November 10, 2016

No such thing as *the* European welfare state

Transfers
(percent of potential GDP)



Transfers
(percent of potential GDP)



Callegari, Drudi, Kuester, “The fiscal mix in the euro-area crisis”
There is no such thing as *the* European welfare state.

This paper's question and setup

- ▶ How best to design automatic stabilizers (in an *ex-ante* welfare sense)?
- ▶ Think of a set of policies: monetary policy (business-cycle), labor-market policy (constant replacement rate; moral hazard-insurance tradeoff).
- ▶ What is the optimal *policy mix*?

- ▶ New-Keynesian, sticky-price core: demand matters; search and matching frictions: equilibrium unemployment endogenous to policy; incomplete markets: no borrowing; no saving in eqbm; idiosyncratic risk: skill risk and unemployment risk.

The paper's findings

- ▶ Unemployment benefits work as automatic stabilizers.
- ▶ If there is business cycle risk, *benefits should be larger*.
- ▶ Considerable welfare gains from optimal stabilizers (on the order of 1% of permanent consumption).

- ▶ Key channel: welfare programs reduce idiosyncratic residual earnings risk. Parametric link from “slack variable” (the unemployment rate) to idiosyncratic risk, treated as structural. Reducing fluctuations in “slack variable” then mechanically reduce idiosyncratic risk.

- ▶ *Policy mix*: Need for stabilizers if other policies do not stabilize cycle.

Taylor rule and the natural rate

$$\ln(R) = \omega_{\pi} \ln(\pi) + \omega_x \ln(x)$$

- ▶ No reference to natural rate, r_n
- ▶ If recessions come with an increase in idiosyncratic risk \Rightarrow wish to save more \Rightarrow natural rate falls. If mp doesn't accommodate by reducing R , deepen recession.

Unemployment risk and the natural rate I

- ▶ Focus on flex-price economy.
- ▶ For the employed:

$$u_c(c_e) = \beta E(1 + r_n)[\pi'_e u_c(c'_e) + (1 - \pi'_e)u_c(c'_u)]$$

- ▶ For the unemployed

$$u_c(c_u) > \beta E(1 + r_n)[\pi'_e u_c(c'_e) + (1 - \pi'_e)u_c(c'_u)]$$

- ▶ Due to borrowing constraint, the unemployed lack the liquidity to self-insure. Will not matter directly for r_n .

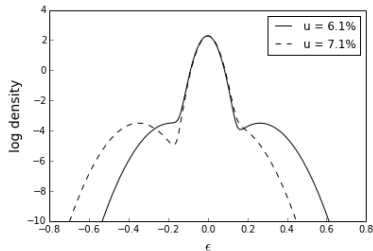
Unemployment risk and the natural rate II

- ▶ How can we increase natural rate in recession:

$$u_c(c_e) = \beta E(1 + r_n)[\pi'_e u_c(c'_e) + (1 - \pi'_e)u_c(c'_u)]$$

- ▶ If u concave: redistribute consumption from the rich (unemployed) to the poor (employed).
- ▶ Progressivity of tax code: applies to both employed and unemployed.
- ▶ Benefits indexed by skills and replacement rate “high”.
- ▶ That means progressivity of income tax simply cannot redistribute much? Doesn't stabilize r_n .

Idiosyncratic skill risk



62

Figure 5: Properties of $F(\epsilon)$.

- ▶ This leaves the slack-dependent skill risk as the main channel.

Question 1: “Casual” evidence for main channel

- ▶ That is, the *structural* link between policy and idiosyncratic residual earnings risk?
 - ▶ Across countries?
 - ▶ Idiosyncratic risk lower in the Great Moderation than prior?
- ▶ Report on the implications of skill-risk (moments of earnings distribution, business cycle moments)

Result: Optimal choice of UI generosity

Proposition 1:

$$E \sum_t \beta^t \left[\text{Baily-Chetty terms} + \frac{dW_t}{dx_t} \frac{dx_t}{db} \right]$$

$$E \sum_t \beta^t \left[\frac{dW_t}{dx_t} \frac{dx_t}{db} \right] = \sum_t \beta^t \left\{ E \left[\frac{dW_t}{dx_t} \right] E \left[\frac{dx_t}{db} \right] + \text{Cov} \left[\frac{dW_t}{dx_t}, \frac{dx_t}{db} \right] \right\}$$

- ▶ Suppose economy on average efficient.
- ▶ Suppose raising job-finding rate is most beneficial to welfare precisely when the job-finding rate *rises* most with benefits.
- ▶ Counterexamples where automatic stabilizers may not be successful (e.g., S+M with wages rigid to TFP, but not benefits).
- ▶ So, ultimately, it is a quantitative question (back to Question 1).

Result: Decomposing welfare gains

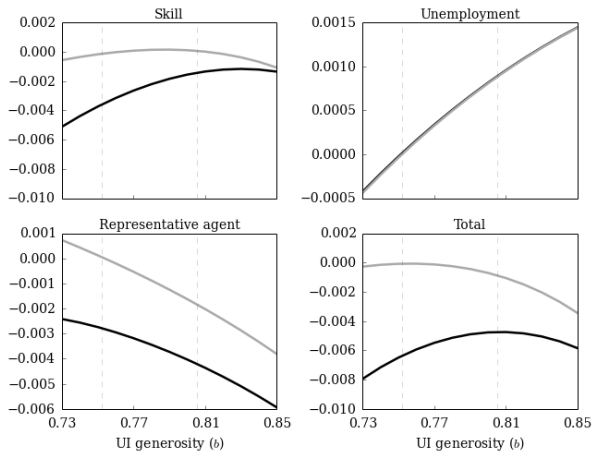


Figure 3: Decomposition of welfare in consumption equivalent units. $\tau = 0.26$. With aggregate shocks (black) and without (gray). Vertical lines show the optimal b with and without aggregate shocks.

Question 2: what happens to inequality

- ▶ How to translate the exercise to politics?
- ▶ $c_{u,t} = b \cdot$ net wage income of the employed in t .
- ▶ This means: in a recession the replacement rate out of *past* (or steady-state) income falls.
- ▶ How much does consumption inequality rise: c_u/c_e ?
- ▶ $c_{e,t} =$ net wage income of the employed in $t +$ profits
- ▶ countercyclical markups. Does replacement rate if expressed as c_u/c_e fall in recession? How much?

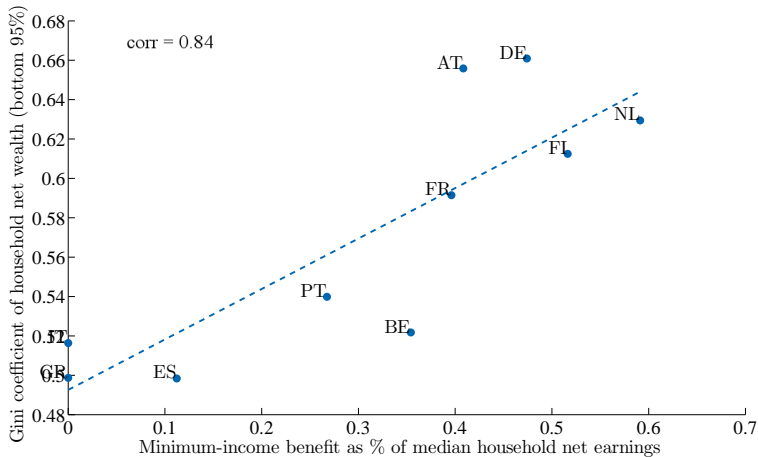
Question 3: capital and self-insurance?

- ▶ Provide benefits.
- ▶ Or insure through having jobs.
- ▶ Or, self-insurance. Cyclical effect depends on what people invest in:
 - ▶ Invest in one-period inside bonds (no direct demand effect). (r_t^n down)
 - ▶ Invest in physical capital or employment relationships (direct effects on demand and future production) (r_t^n up)
- ▶ Long-run effects.

Pham-Dao (2016) “Public Insurance and Wealth Inequality: A Euro Area Analysis”

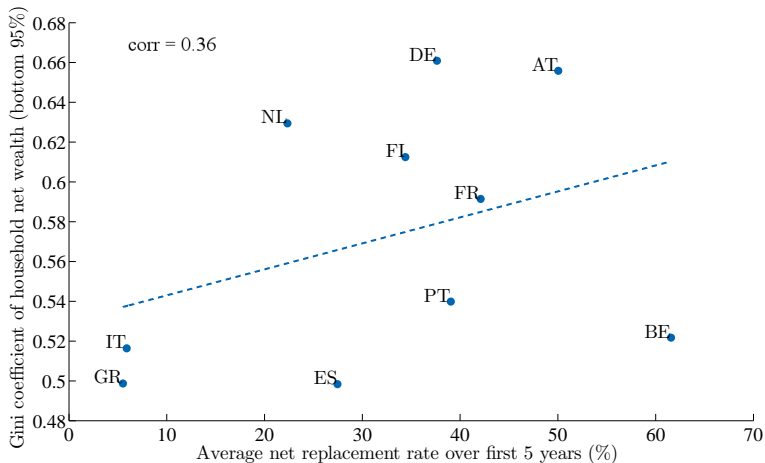
Heterogenous households, earnings risk, unemployment risk, social insurance:

Welfare policies explain 2/3 of difference in wealth inequality across the euro area.



Source: HFCS (~2010); EuMin database, (2001-2008)

Figure 3: Wealth inequality and unemployment insurance



Nothing but praise

- ▶ Important topic.
- ▶ Thorough and insightful.
- ▶ No fine tuning of cyclical fiscal policy.
- ▶ Focus on permanent rules.

- ▶ What else can you ask for.