PROBLEM SET - Lucas Stokey (1983)

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Part One

Question 1 - $t \geq 1$

(a) Plot the history-independent and time-invariant tax $\tau(\phi)$

(b) Plot the history-independent ant time invariant allocations $\{c(\phi, g), n(\phi, g)\}$

We compute the allocations from the star equation and the ressource constraint using a non-linear solver.

$$\begin{cases} (1+\phi)(u_c(g) + u_n(g)) + \phi(u_{cc}(g)c(g) + n(g)u_{nn}(g)) & = 0 \\ c(g) + g & = n(g) \end{cases}$$

(c) Write the implementability constraint recursively to find $\{b(\phi, g)\}$ and plot debt policies as a function of ϕ

From the IC we have

$$u_c(g)c(g) + u_n(g)n(g) + \beta \sum_{g'} \Pi(g'|g) u_c(g') b(g') = u_c(g) b(g)$$

We rewrite the problem in matrix form to solve the linear system and because it makes it easy to compute b for larger vector of states. We have

$$b = Ab + k$$

Where

$$b = [b_{g_1} \dots b_{g_n}]' \tag{1}$$

$$A = \beta((U_c)^{\odot -1} U_c') \odot \Pi \tag{2}$$

$$U_c = [u_{c,g_1} \dots u_{c,g_n}]' \tag{3}$$

$$\Pi = \begin{bmatrix} \pi(g_1|g_1) & \dots & \pi(g_n|g_1) \\ \vdots & \ddots & \vdots \\ \pi(g_1|g_n) & \dots & \pi(g_n|g_n) \end{bmatrix} \tag{4}$$

$$k = \begin{bmatrix} c_{g_1} + \frac{u_{n,g_1}}{u_{n,g_1}} n_{g_1} \\ \vdots \\ c_{g_n} + \frac{u_{n,g_n}}{u_{n,g_n}} n_{g_n} \end{bmatrix} \tag{5}$$

Where $\odot$ is the Hadamard product (or *elementwise* operator)

The solution to compute debt for each states at a given value of ϕ writes

$$b = (I - A)^{-1}k$$

(d) What can you say about the relationship between ϕ and τ? Between ϕ and c?

Φ is the Lagrange multiplier of the implementability constraint in the Ramsey plan. It is a measure of the distortion implied by the tax. Hence, it is straightforward to have a positive relationship between the two.

We observe a negative relationship between ϕ and c. This is explained by the substitution effect implied by the tax, which lowers the labor supply and hence the revenue and the consumption.

Question two - $t = 0$

(a) Compute allocations $\{c_0(b_0, \phi), n_0(b_0, \phi)\}$

As before, we use the ressource constraint and the star equation, but in time zero. We get c_0 and n_0 as a function of the initial debt b_0 and the lagrange multiplier ϕ.

(b) Use the bisection method to find $\phi(b_0)$

In order to compute $\phi(b_0)$ we use a bisection algorithm on the implementability constraint. We have $IC = F(\phi, b_0, c_0(\phi, b_0), n_0(\phi, b_0)) = F(\phi, b_0)$. For a given value of b_0, written $\bar{b}_0$, we find ϕ with the following algorithm:

- Initialization
  - Define a lower bound ϕ_L and upper bound ϕ_U on ϕ
  - Define a tolerance level ϵ
- `While` $|IC(\phi_U, \bar{b}_0) - IC(\phi_L, \bar{b}_0)| > \epsilon$
  - $\phi_M \leftarrow \frac{\phi_L + \phi_U}{2}$
  - `If` $IC(\phi_M, \bar{b}_0) = 0$
    - `BREAK`
  - `Else if` $IC(\phi_M, \bar{b}_0) \times IC(\phi_L, \bar{b}_0) > 0$
    - $\phi_L \leftarrow \phi_M$
  - `Else`
    - $\phi_U \leftarrow \phi_M$

(c) What can you say about the relation between b_0 and ϕ

The initial debt b_0 and the distortion measure ϕ are positively related. This is because the debt need to be repaid with distortionary taxes. We see that ϕ is positive even with no initial debt, because the government needs to finance public expenditures in $t = 0$. The distortion disappears for $-b_0 = g_0 = 0.1$, that is when the government can fully finance public expenditures using its initial wealth.

Part Three

Simulating the economy is now straightforward. Fixing b_0 allows the computation of $\phi(b_0)$ which itself allows for the computation of allocations at time zero and for $t \geq 1$

(a) Assume $b_0 = 0$. Simulate the economy for 100 periods.

The tax rate is constant in every periods. If $b_0 = 0$, then $t = 0$ is not different from any other period because $(\star) = (\star_0)$

(b) Assume $b_0 = 0.1$. Simulate the economy for 100 periods.

In $t = 0$ the tax rate is below its value at $t \geq 1$, it is also greater than the case where $b_0 = 0$, this is due to the fact that the government needs to finance debt. The government sets τ_0 lower than $\{\tau_t\}_{t\geq 1}$ to incite households to supply labor. This creates a time inconsistency issue because one should expect the government to repeat this behavior at each period.

(c) Assume $b_0 = -0.1$. Simulate the economy for 100 periods.

The government has enough assets to finance its expenses so it doesn't need to tax labor, thus $\tau_t = 0 \ \ \forall\, t$

(d) Extension, AR(1) process for g using Tauchen method

In this extension, we use the Tauchen method to simulate an AR(1) process of g_t.