Optimal Taxation with Incomplete Markets

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Lucas and Stokey, 1983

. . . the option to issue state-contingent debt is important: tax policies that are optimal under uncertainty have an essential 'insurance' aspect to them.

Commitment, representative agent, no capital

- **Incomplete markets**
  $\rightarrow$ A single, possibly risky asset
- **Linear tax schedules**
  $\rightarrow$ Proportional tax on labor earnings (maybe plus *nonnegative* transfers)
- **Aggregate shocks**
  $\rightarrow$ To productivities, government expenditures

Questions

1. Should a government accumulate or decumulate assets?
2. Why might different economic fundamentals lead governments to want different amounts of debt?
3. Existing answers hinge on polar assumptions:
   - Lucas Stokey (1984), complete markets: non history dependent debt quantities inherited from initial debt
   - AMSS (2002), a risk-free bond only, quasi-linear preferences: govt. accumulates *assets* sufficient to finance activities using interest revenues
4. Unknown after AMSS (2002): what if interest rates fluctuate?

Environment

- **Uncertainty**: Markov aggregate shocks $s_t \in \mathcal{S}$; $S \times S$ stochastic matrix Π; $g_t = g(s_t); \theta_t = \theta(s_t)$
- **Demography**: Infinitely lived representative agent plus a benevolent planner
- **Preferences** (representative household)

$$\mathbb{E}_0 \sum_{t=0}^{\infty} \beta^t U\left(c(s^t), l(s^t)\right)$$

- **Technology**: Output $y_t = \theta_t l_t$

Environment, II

- **Asset market**:
  - $S \times S$ matrix $\mathbb{P}$ with time t payoff being
  $$p_t = \mathbb{P}(s_t | s_{t-1})$$
- **Linear Taxes**: Representative consumer's tax bill
  $$-T_t + \tau_t \theta_t l_t, \;\; T_t \geq 0$$
- **Budget constraints** q_t is price of asset
  - Household: $c_t + b_t = (1 - \tau_t)\,\theta_t l_t + \frac{p_t}{q_{t-1}} b_{t-1} + T_t$
  - Government: $g_t + B_t + T_t = \tau_t \theta_t l_t + \frac{p_t}{q_{t-1}} B_{t-1}$
-
  - **Feasibility**: $c_t + g_t = \theta_t l_t$
  - **Market Clearing for Asset**: $b_t + B_t = 0$
- **Initial conditions**: Assets $b_{-1} = -B_{-1}$ and s_{-1}

Ramsey Problem

Definition
Allocation, price system, government policy

Definition
Competitive equilibrium: Given $(b_{-1} = -B_{-1}, s_{-1})$ and $\{\tau_t, T_t\}_{t=0}^{\infty}$, all allocations are individually rational, markets clear [1]

Definition
Optimal competitive equilibrium: A welfare-maximizing competitive equilibrium for a given (b_{-1}, B_{-1}, s_{-1})

[1] Usually, we impose only "natural" debt limits.

Ramsey problem

1. **Primal approach**: To eliminate tax rates and prices, use household's first order conditions:

$$U_{c,t} q_t = \beta \mathbb{E}_t p_{t+1} U_{c,t+1}$$

$$(1 - \tau_t) \theta_t U_{c,t} = -U_{l,t}$$

2. **Implementability constraints**: Derive by iterating the household's budget equation forward at every history $\Rightarrow$ for $t \geq 1$, these impose *measurability restrictions* on Ramsey allocations
3. The $t \geq 1$ **measurability constraints** contribute the only difference from Lucas-Stokey's Ramsey problem.

Ramsey problem

4. **Transfers:** We temporarily restrict transfers $T_t = 0 \ \forall t$. This is convenient for our analytical results. We eventually show that this assumption is not restrictive.

Ramsey problem (Lucas-Stokey)

$$\max_{\{c_t, l_t\}} \mathbb{E}_0 \sum_{t=0}^{\infty} \beta^t U(c_t, l_t)$$

subject to

(a) **Feasibility**

$$c_t + g_t = \theta_t l_t$$

(b) **Implementability constraint**

$$b_{-1} = \frac{1}{U_{c,0}} \mathbb{E}_0 \sum_{t=0}^{\infty} \beta^t \left(U_{c,t} c_t + U_{l,t} l_t \right)$$

Ramsey problem (BEGS)

$$\max_{\{c_t, l_t, b_t\}} \mathbb{E}_0 \sum_{t=0}^{\infty} \beta^t U(c_t, l_t)$$

(a) **Feasibility**

$$c_t + g_t = \theta_t l_t$$

(b) **Lucas-Stokey implementability constraint**

$$b_{-1} = \frac{1}{U_{c,0}} \mathbb{E}_0 \sum_{t=0}^{\infty} \beta^t \left(U_{c,t} c_t + U_{l,t} l_t \right)$$

(c) **Measurability constraints**

$$\frac{b_{t-1} U_{c,t-1}}{\beta} = \frac{\mathbb{E}_{t-1} p_t U_{c,t}}{p_t U_{c,t}} \mathbb{E}_t \sum_{j=0}^{\infty} \beta^j \left(U_{c,t+j} c_{t+j} + U_{l,t+j} l_{t+j} \right) \text{ for } t \geq 1$$

Roadmap, analytic strategy

- Ramsey allocation – especially asymptotic properties – varies with **asset returns** that reflect
  - Prices $\{q_t(s^t|B_{-1}, s_{-1})\}_t$
  - Payoffs $\mathbb{P}$
- To focus on the exogenous $\mathbb{P}$ part of returns, we first study quasi-linear preferences that pin down $q_t = \beta \mathbb{E}_t \mathbb{P}(s_{t+1}|s_t)$
- Activate risk aversion and fluctuating q_t later

Battlefield

What is government debt in long-run?

	risk-free bond	risky bond
Quasi-Linear		
Risk Aversion		

Analysis with quasi-linear preferences

Quasilinear preferences $U(c, l) = c - \frac{l^{1+\gamma}}{1+\gamma}$
To characterize **long-run** debt and taxes, we construct and then invert mapping $\mathbb{P}^*(b)$

- Given **arbitrary** initial govt. assets b_{-1}, what is an **optimal** asset payoff matrix $\mathbb{P}^* = \mathbb{P}^*(b_{-1})$?
- Under a Ramsey plan for an **arbitrary** payoff matrix $\mathbb{P}$, when would $b_t \to b^*$, where

$$\mathbb{P} = \mathbb{P}^*(b^*) \text{ or } b^* = \mathbb{P}^{*-1}(\mathbb{P})?$$

Roadmap, the answers

- We first reverse engineer an optimal $\mathbb{P}^*(b_{-1})$ from a Lucas-Stokey Ramsey allocation
- In a binary IID world, we identify a big set of $\mathbb{P}$'s that imply that b_t under a Ramsey plan converges to b^* that solves

$$\mathbb{P} = \mathbb{P}^*(b^*)$$

- For more general shock structures, we numerically verify an ergodic set of b_t's hovering around $\tilde{b}$. The optimal $\mathbb{P}^*$ associated with $\tilde{b}$ seems close to $\mathbb{P}$:

$$\mathbb{P} \approx \mathbb{P}^*(\tilde{b})$$

Optimal asset payoff matrix $\mathbb{P}^*$

1. Given b_{-1}, compute a Lucas-Stokey Ramsey allocation
2. Notice that the measurability constraints are invariant to scaling of p_t by a constant k_{t-1} that can depend on s^{t-1}.
3. From this class we select a p_t that imposes the normalization $\mathbb{E}_{t-1} U_{c,t} p_t = 1$

$$p_t = \frac{\beta}{U_{c,t-1} b_{t-1} U_{c,t}} \mathbb{E}_t \sum_{j=0}^{\infty} \beta^j \left(U_{c,t+j} c_{t+j} + U_{l,t+j} l_{t+j} \right)$$

4. By construction, p_t disarms the time $t \geq 1$ measurability constraints.
5. Using the fact that the Lucas-Stokey allocation is stationary, we can construct the optimal payoff matrix

$$\mathbb{P}^*(s_t, s_{t-1} | b_{-1}) = p_t$$

Quasilinear preferences $U(c, l) = c - \frac{l^{1+\gamma}}{1+\gamma}$

Given initial assets b_{-1}, let $\mu(b_{-1})$ be the Lagrange multiplier on the Lucas-Stokey implementability constraint

1. **Multiplier $\rightarrow$ Tax rate:**

$$\tau(\mu) = \frac{\gamma\mu}{(1+\gamma)\mu - 1}$$

2. **Tax rate $\rightarrow$ net of interest surplus:**

$$S(s, \tau) = \theta(s)^{\frac{\gamma}{1+\gamma}}(1-\tau)^{\frac{1}{\gamma}}\tau - g(s)$$

3. **Surplus $\rightarrow$ optimal payoff structure:**

$$\mathbb{P}^*(s, s_-|b_{-1}) = (1-\beta)\frac{S(s,\tau)}{\mathbb{E}_{s_-}S(s,\tau)} + \beta$$

Initial holdings influence optimal asset payoff structure

Denote state s as "adverse" if it has "high" govt. expenditures or "low " TFP; formally, s is "adverse" if

$$g(s)\mathbb{E}_{s\_}\theta^{\frac{\gamma}{1+\gamma}} - \theta(s)^{\frac{\gamma}{1+\gamma}}\mathbb{E}_{s\_}g > 0$$

Properties of optimal payoff matrix $\mathbb{P}$

- With positive initial govt. assets: want an asset that pays *more* in "adverse" states
- With negative initial govt. assets: want an asset that pays *less* in "adverse" states

Optimal Payoff Structure: TFP shocks

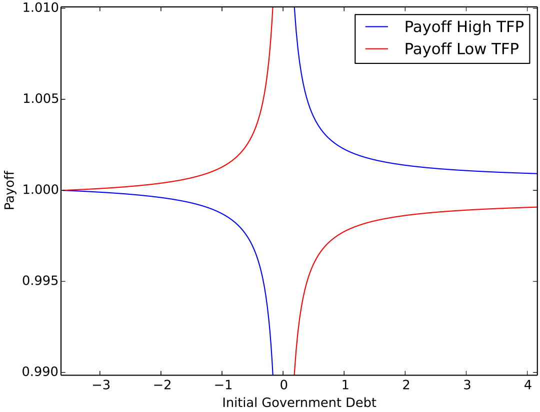


Figure: Optimal asset payoff structure as a function of initial government debt when TFP follows a 2 shock i.i.d process

Optimal Payoff Structure: Expenditure shocks

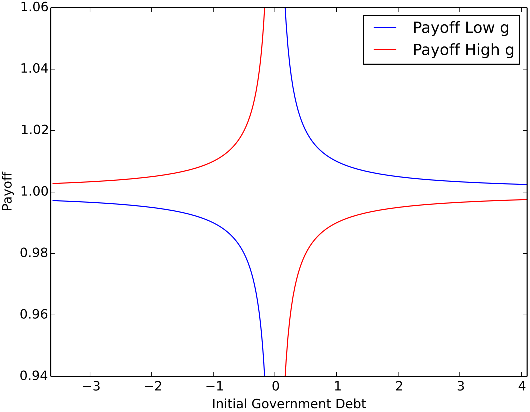


Figure: Optimal asset payoff structure as a function of initial government debt when government expenditures follow 2 shock i.i.d process

Inverting the $\mathbb{P}^*$ mapping

1. **Exogenous payoff structure:** Suppose $\mathbb{P} \neq \mathbb{P}^*(b_{-1})$
2. **Steady States:** A steady state is a government debt b^* such that

$$b_t = b^* \text{ implies } b_{t+\tau} = b^* \quad \forall \tau > 0$$

3. **Characterization:** Given an asset payoff structure $\mathbb{P}$
   - Does a steady state exist? Is it unique?
   - Value of b^*?
   - For what *initial government debts* b_{-1} does b_t converge to b^*?

Existence and $\mathbb{P}^{*-1}$

When shocks are i.i.d and take two values

1. $\mathbb{P}(s_{-}, s)$ is independent of s_{-} (so $\mathbb{P}$ can be a vector)
2. Under the normalization $q_t = \beta$, $\mathbb{E}\mathbb{P}(s) = 1$. Payoffs are then determined by a scalar p.
   - p is the asset's payoff in the "good" state s
   - A risk-free bond is a security for which $p = 1$
3. A steady state is obtained by inverting the optimal payoff mapping p^*

$$b^* \text{ satisfies } p = p^*(b^*) \text{ or } p^{*-1}(p) = b^*$$

One equation in one unknown b^*

Existence regions in p space

The payoff p in good state $\in (0, \infty)$.
We categorize a set of economies with different asset payoffs into 3 regions via thresholds $\alpha_2 \geq \alpha_1 \geq 1$

- Low enough $p(\leq \alpha_1)$: government holds assets in steady state
- High enough $p(\geq \alpha_2)$: government issues debt in steady state
- Intermediate $p(\alpha_1 > p > \alpha_2)$: steady state does not exist

Thresholds: $\alpha_1 < \alpha_2$

- With only government expenditure shocks

$$\alpha_1 = 1 \text{ and } \alpha_2 = (1-\beta)\frac{\theta^{\frac{\gamma}{1+\gamma}}\left(\frac{1}{1+\gamma}\right)^{\frac{1}{\gamma}}\frac{\gamma}{1+\gamma} - g(s_1)}{\theta^{\frac{\gamma}{1+\gamma}}\left(\frac{1}{1+\gamma}\right)^{\frac{1}{\gamma}}\frac{\gamma}{1+\gamma} - \mathbb{E}g} + \beta > 1$$

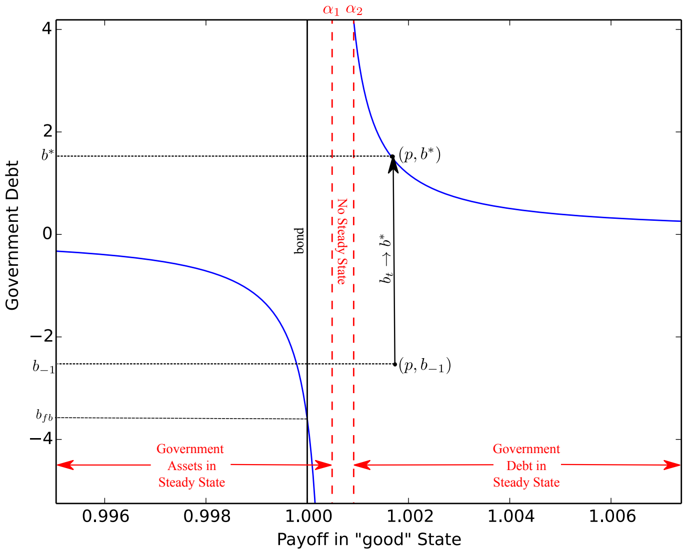
- With only TFP shocks

$$\alpha_1 = (1-\beta)\frac{\theta(s_1)^{\frac{\gamma}{1+\gamma}}}{\mathbb{E}\theta^{\frac{\gamma}{1+\gamma}}} + \beta > 1$$

and

$$\alpha_2 = (1-\beta)\frac{\theta(s_1)^{\frac{\gamma}{1+\gamma}}\left(\frac{1}{1+\gamma}\right)^{\frac{1}{\gamma}}\frac{\gamma}{1+\gamma} - g}{\mathbb{E}\theta^{\frac{\gamma}{1+\gamma}}\left(\frac{1}{1+\gamma}\right)^{\frac{1}{\gamma}}\frac{\gamma}{1+\gamma} - g} + \beta > \alpha_1$$

Existence regions in p space



Convergence

- Our analysis verifies existence of a steady state in a 2-state i.i.d. economy.
- To study long-run properties of a Ramsey allocation, we want to know whether steady state is stable
- **Risk-adjusted martingale:**
  The Lagrange multiplier μ_t on the implementability constraint satisfies
  $$\mu_t = \mathbb{E}_t p_{t+1} \mu_{t+1}$$
  or
  $$\mathbb{E}_t \mu_{t+1} = \mu_t - Cov_t(p_{t+1}, \mu_{t+1})$$
- **Stability criterion:** Away from a steady state, is the drift of μ_t big enough?

Characterizing convergence under quasi-linearity, iid, and $S = 2$

- Reminder: p is the payoff in the "good" state.
- We partition the "p space" into stable and unstable regions

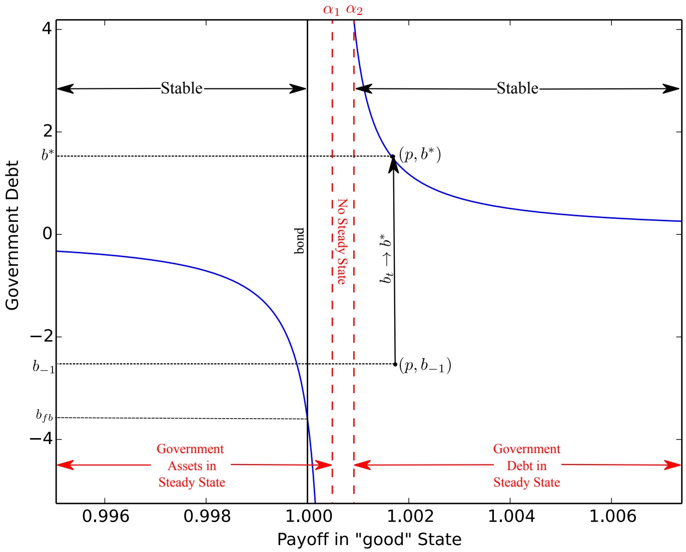
Theorem

Let b^* denote steady state govt. debt and b_{fb} be govt. debt that supports the first-best allocation with complete markets. Then

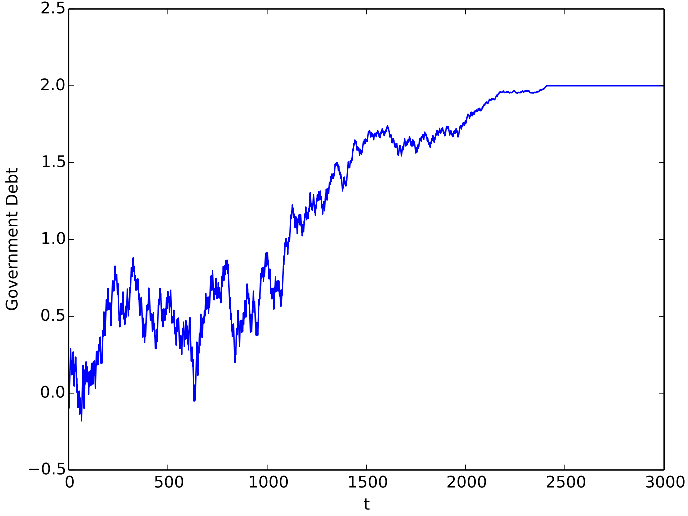
1. **Low** *p: If $p \leq \min(\alpha_1, 1)$ then $b_{fb} < b^* < 0$ and $b_t \to b^*$ with probability 1.*
2. **High** *p: If $p \geq \alpha_2$ then $0 < b^*$ and $b_t \to b^*$ with probability 1.*

For the intermediate region where b^* either does not exist or is unstable, there is a tendency to run up debt

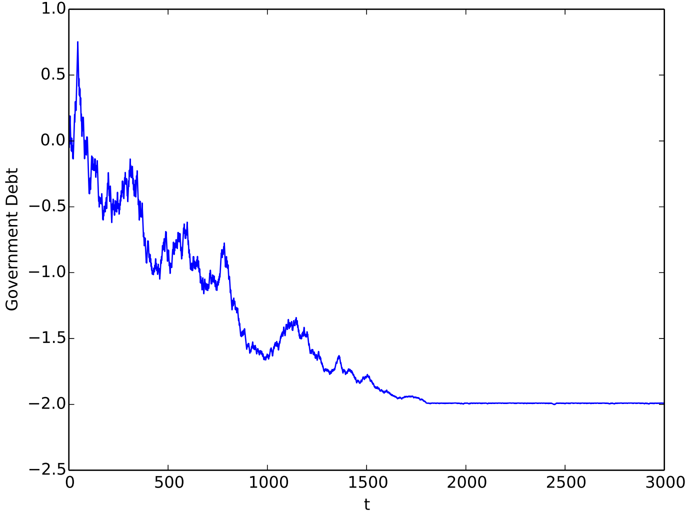
Stability regions



A sample path with $p > 1$



A sample path with $p < 1$



Intuition for Convergence

- The Ramsey policy with incomplete markets smooths the welfare costs of distorting labor taxes by manipulating debt positions
- With a risk-free bond, the marginal cost of raising funds μ_t is a martingale. Changes in debt levels help smooth tax distortions across time.
- If the payoff matrix of the asset differs across states, then by generating state contingent revenues, the level of government debt smooths tax distortions across states.
- The steady state b^* is a unique debt level that provides enough "state contingency" completely to overcome missing assets markets
- When issuing debt, the government takes takes this benefit into account by distorting the martingale and either accumulating or decumulating debt.
- Although this is achieved by raising taxes, locally the welfare costs of taxes are second order and dominated by the gains from coming closer to b^*, which are first order in terms of welfare.

Outcomes with quasi-linear preferences

Outcomes:

1. Often $b_t \to b^*$ when the aggregate state follows a 2-state i.i.d. process
2. The level and sign of b^* depend on the **exogenous payoff structure** $\mathbb{P}$
3. The limiting allocation corresponds to a complete market Ramsey allocation for initial govt. debt b^*

Turning on risk-aversion

Modifications:

- Another source of return fluctuations – the risk-free interest rate
- Marginal utility adjusted debt encodes history dependence
- With binary i.i.d shock shock process, $x_t = u_{c,t} b_t$ converges
- Long-run properties of x_t depend on equilibrium returns $R_{t,t+1} = \frac{\mathbb{P}(s_t, s_{t+1})}{q_t(s^t)}$. Now q_t varies in interesting ways

Roadmap, II

Two subproblems

1. $t = 0$ Bellman equation in value function $W(b_{-1}, s_0)$
2. $t \geq 1$ Bellman equation in value function $V(x, s_{\_})$

Seek steady states x^* such that $x_t \to x^*$

A Recursive Formulation

1. Commitment implies that government actions at $t \geq 1$ are constrained by the public's anticipations about them at $s < t$
2. This contributes additional state variables like marginal utility of consumption
3. Scaling the budget constraint by marginal utility makes Ramsey problem recursive in $x = U_c b$

$$\frac{x_{t-1} p_t U_{c,t}}{\beta \mathbb{E}_{t-1} p_t U_{c,t}} = U_{c,t} c_t + U_{l,t} l_t + x_t$$

Bellman equation for $t \geq 1$ (*ex ante*)

$$V(x, s_-) = \max_{c(s), l(s), x'(s)} \sum_s \Pi(s, s_-)\Big(U(c(s), l(s)) + \beta V(x'(s), s)\Big)$$

subject to $x'(s) \in [\underline{x}, \overline{x}]$

$$\frac{x\mathbb{P}(s)U_c(s)}{\beta \mathbb{E}_{s_-}\mathbb{P}Uc} = U_c(s)c(s) + U_l(s)l(s) + x'(s)$$

$$c(s) + g(s) = \theta(s)l(s)$$

Time 0 Bellman equation (*ex post*)

Given an initial debt b_{-1}, state s_0, and continuation value function $V(x, s_{\_})$

$$W(b_{-1}, s_0) = \max_{c_0, l_0, x_0} U(c, l) + \beta V(x_0, s0)$$

subject to time zero implementability constraint

$$U_c(c_0, l_0)c + U_l(c_0, l_0)l_0 + x_0 = U_c(c_0, l_0)b_{-1}$$

and resource constraint

$$c_0 + g(s_0) = \theta(s_0)l_0$$

and

$$x_0 \in [\underline{x}, \overline{x}]$$

Progress report

1. Existence proved only under special case of a risk-free bond
   $\mathbb{P}(s|s_-) = 1 \; \forall \; (s, s_-)$
   This focuses attention on *endogenous* component of returns coming from $q_t(s^t)$
2. x^* is an initial condition for which the optimal asset payoff in a LS economy is a risk-free bond

Revisiting steady states with risk aversion

Let $x'(s; x, s_{-})$ be an optimal law of motion for the state variable for the $t \geq 1$ Bellman equation.

Definition

A steady state x^* satisfies $x^* = x'(s; x^*, s_{-})$ for all s, s_{-}

Thus, a steady state is a node at which the continuation allocation and tax rate have no further history dependence.

Existence

1. For a class of economies with separable iso-elastic preferences $U(c,l) = \frac{c^{1-\sigma}}{1-\sigma} - \frac{l^{1+\gamma}}{1+\gamma}$
2. Shocks that take two values and are i.i.d with s_b being the "adverse" state (either low TFP or high govt. expenditures)

Let x_{fb} be a value of the state x from which a government can implement first=best with complete markets

Proposition

Let $q_{fb}(s)$ be the shadow price of government debt in state s using the first best allocation. If

$$\frac{1 - q_{fb}(s_b)}{1 - q_{fb}(s_g)} > \frac{g(s_b)}{g(s_g)} > 1$$

then there exists a steady state with $x_{fb} > x^* > 0$

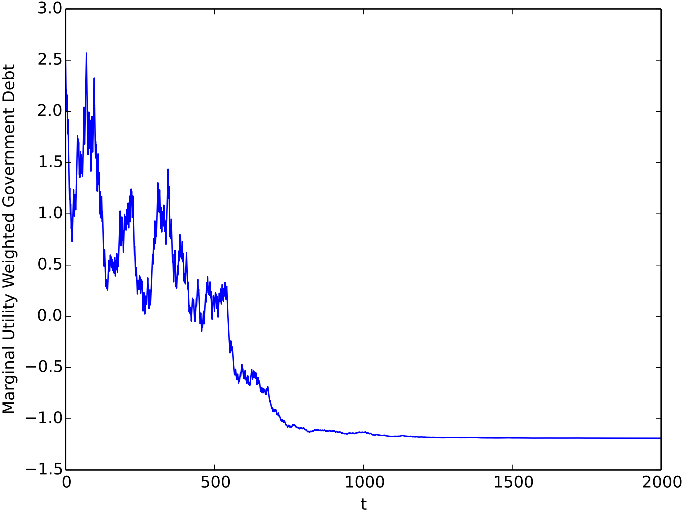
Stability

1. Here interest rates are aligned with marginal utility of consumption; they are low in "good" states (high TFP or low expenditure)
2. In a steady state, the government holds claims against the private sector. Resembles the quasilinear case with low p
3. The incomplete markets Ramsey allocation converges to a Lucas-Stokey Ramsey allocation for all initial conditions

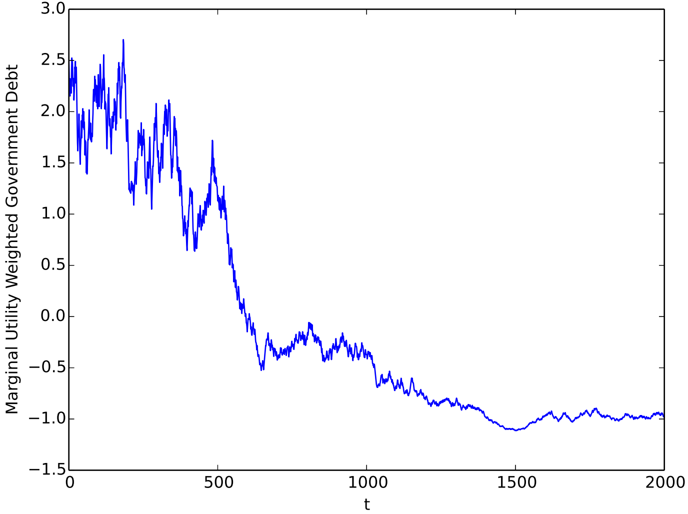
Proposition

Let $\{c_t(s^t), l_t(s^t), x_t(s^{t-1})\}$ *solve the incomplete markets Ramsey problem with* $x_0 > x^*$*. Then* $x_t(s^{t-1}) \to x^*$ *as* $t \to \infty$ *with probability 1 for all initial conditions*

A sample path for 2 state i.i.d. process with risk aversion



A sample path for economy with $S > 2$ states



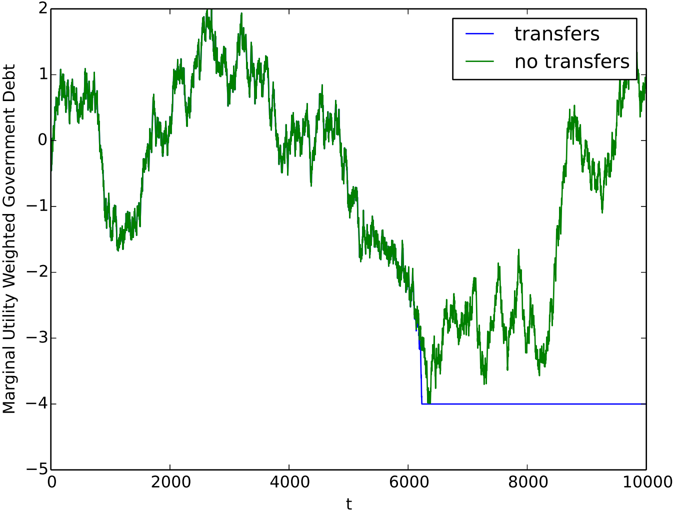
Transfers

- Access to nonnegative transfers makes first-best level of assets trivially a "steady state"
- All results hold *on one side* of steady state

Theorem

With nonnegative lump sum transfers, in cases where a steady state exists and is stable, if the initial debt of the government exceeds its steady state level, the economy converges with probability 1 to the steady state.

Quasilinear preferences and risk-free bond with and without nonnegative transfers



Battlefield

What is government debt in long-run?

With shocks that are IID and take two values

	risk-free bond	risky bond
Quasi-Linear	(AMSS) With $T_t \geq 0$, govt. accumulates enough assets for first best.	Partition payoff space so that govt. either a) issues or b) runs up debt eventually
Risk Aversion	Conditions under which limiting govt. assets $<$ first best	*Conjecture:* Similar to quasi-linear outcomes

We plan to study more general shocks processes

Comparison to literature

1. Angeletos (2002), Buera and Nicolini (2004)
   - Begin with a complete market Ramsey allocation
   - Ask if this can be attained with a limited collection of non-contingent debts of different maturities
2. This paper
   - Begins with an incomplete markets Ramsey allocation
   - Asks whether the long-run allocation coincides with a complete markets Ramsey allocation for some initial govt debt
3. BEGS1 studies a related problem with heterogeneous agents