

ASSIGNMENT II

Vision: This project teaches you to solve for the *stationary equilibrium* and *transition path* in a heterogeneous agent model and analyze the economic results.

- **Problem:** The problem consists of
 1. A number of questions (page 2)
 2. A model (page 3-4)
- **Code:** The problem is designed to be solved with the *GEModelTools* package.
- **Structure:** Your project should consist of
 1. A single self-contained pdf-file with all results
 2. A single Jupyter notebook showing how the results are produced
 3. Well-documented *.py* files
- **Hand-in:** Upload a single zip-file on Absalon (and nothing else)
- **Deadline:** 24th of November 2023
- **Exam:** Your Assignment II will be a part of your exam portfolio.
You can incorporate feedback before handing in the final version.

HANC with a Welfare State

- a) **Find the stationary equilibrium without a government** ($G_t = L_t^G = \chi_t = 0$).
Report the expected discounted utility.
Code is provided as a starting point.
- b) **Find optimal welfare policies I.** Choose G_t and L_t^G to maximize expected discounted utility in the stationary equilibrium. Keep $\chi_t = 0$. Report G_t/Y_t .
Hint: You can use that $G_t = \Gamma^G L_t^G$ is always optimal cf. 8
- c) **Find optimal welfare policies II.** Repeat b) allowing for $\chi_t \neq 0$. Discuss whether positive or negative transfer are optimal.
- d) **Increased TFP.** Repeat question c) with $\Gamma^Y = 1.1$. Comment on the differences.
- e) **Transition path.** Compute the transition path from the stationary equilibrium in c) to the one in d). Argue for your choice of policies path of G_t , L_t^G and χ_t .

1. Model

Households. The model has a continuum of infinitely lived households indexed by $i \in [0, 1]$. Households are *ex ante* homogeneous. Households choose consumption and how much labor to supply. Savings is in terms of capital, which is rented out to firms at the rental rate, r_t^K . There are no possibilities to borrow. Households are *ex post* heterogeneous in terms of their stochastic labor productivity, z_{it} , and their (end-of-period) savings, a_{it-1} . The distribution of households over idiosyncratic states is denoted \underline{D}_t before shocks are realized and \mathbf{D}_t afterwards. The real wage is w_t , and real-profits are Π_t . The government imposes a proportional tax rate, τ_t , and provides real lump-sum transfers is χ_t and a flow of services S_t . Households choose consumption, c_{it} , and labor supply, ℓ_{it} .

The utility function is

$$u(c_{it}, S_t, \ell_{it}) = \frac{c_{it}^{1-\sigma}}{1-\sigma} + \frac{(S_t + \underline{S})^{1-\omega}}{1-\omega} - \varphi \frac{\ell_{it}^{1+\nu}}{1+\nu}. \quad (1)$$

The household problem is

$$\begin{aligned} v_t(z_{it}, a_{it-1}) &= \max_{c_{it}, \ell_{it}} u(c_{it}, S_t, \ell_{it}) + \beta \mathbb{E}_t [v_{t+1}(z_{it+1}, a_{it})] \\ \text{s.t. } a_{it} + c_{it} &= (1 + r_t)a_{it-1} + (1 - \tau_t)w_t z_{it} \ell_{it} + \chi_t + \Pi_t \\ \log z_{it+1} &= \rho_z \log z_{it} + \psi_{it+1}, \quad \psi_{it+1} \sim \mathcal{N}(\mu_\psi, \sigma_\psi), \quad \mathbb{E}[z_{it}] = 1 \\ a_{it} &\geq 0. \end{aligned} \quad (2)$$

where $r_t \equiv r_t^K - \delta$. The expected discounted utility is

$$\bar{v}_t = \sum_{k=0}^{\infty} \beta^k \int u(c_{it}, S_t, \ell_{it}) d\mathbf{D}_{t+k}. \quad (3)$$

The aggregate quantities of central interest are

$$C_t^{hh} = \int c_{it} d\mathbf{D}_t \quad (4)$$

$$L_t^{hh} = \int \ell_{it} z_{it} d\mathbf{D}_t \quad (5)$$

$$A_t^{hh} = \int a_{it} d\mathbf{D}_t \quad (6)$$

From here on the sub-script i is left out if not strictly necessary.

Firms. A representative firm rents capital, K_{t-1} , and hires labor L_t^Y to produce goods, with the production function

$$Y_t = \Gamma^Y K_{t-1}^\alpha (L_t^Y)^{1-\alpha} \quad (7)$$

where Γ^Y is TFP and α is the Cobb-Douglas weight parameter on capital. Capital depreciates with the rate $\delta \in (0, 1)$. The real rental price of capital is r_t^K and the real wage is w_t . Profits are $\Pi_t = Y_t - w_t L_t^Y - r_t^K K_{t-1}$. The households own the representative firm in equal shares.

The law-of-motion for capital is $K_t = (1 - \delta)K_{t-1} + I_t$.

Government.

The government purchases goods, G_t , and hire labor L_t^G , to produce government services according to

$$S_t = \min\{G_t, \Gamma^G L_t^G\} \quad (8)$$

The government runs a balanced budget each period such that

$$G_t + w_t L_t^G + \chi_t = \int \tau_t w_t \ell d\mathbf{D}_t = \tau_t w_t L_t^{hh}$$

Market clearing. Market clearing implies

1. Asset market: $K_t = A_t^{hh}$
2. Labor market: $L_t^Y + L_t^G = L_t^{hh}$
3. Goods market: $Y_t = C_t^{hh} + G_t + I_t$

2. Calibration

1. **Preferences:** $\sigma = \omega = 2, \underline{S} = 10^{-8}, \varphi = 1.0, \nu = 1.0$
2. **Income process:** $\rho_z = 0.96, \sigma_\psi = 0.15,$
3. **Production:** $\Gamma^Y = \Gamma^G = 1, \alpha_{ss} = 0.30, \delta = 0.10$

3. Solving the household problem

The envelope condition implies

$$\underline{v}_t(z_t, a_{t-1}) = (1 + r_t^K - \delta)c_t^{-\sigma} \quad (9)$$

The first order conditions imply

$$c_t = (\beta \mathbb{E}(\underline{v}_{t+1}(z_{t+1}, a_t))^{-\frac{1}{\sigma}} \quad (10)$$

$$\ell_t = \left(\frac{(1 - \tau_t)w_t z_t}{\varphi} \right)^{\frac{1}{\nu}} c_t^{-\sigma/\nu} \quad (11)$$

The household problem can be solved with an extended EGM:

1. Calculate c_t and ℓ_t over end-of-period states from FOCs
2. Construct endogenous grid $m_t = c_t + a_t - (1 - \tau_t)w_t \ell_t z_t$
3. Use linear interpolation to find consumption $c^*(z_t, a_{t-1})$ and labor supply $\ell^*(z_t, a_{t-1})$ with $m_t = (1 + r_t)a_{t-1}$
4. Calculate savings $a^*(z_t, a_{t-1}) = (1 + r_t)a_{t-1} + (1 - \tau_t)w_t \ell_t^* z_t - c_t^*$
5. If $a^*(z_t, a_{t-1}) < 0$ set $a^*(z_t, a_{t-1}) = 0$ and search for ℓ_t such that $f(\ell_t) \equiv \ell_t - \left(\frac{(1 - \tau_t)w_t z_t}{\varphi} \right)^{\frac{1}{\nu}} c_t^{-\sigma/\nu} = 0$ holds and $c_t = (1 + r_t)a_{t-1} + (1 - \tau)w_t \ell_t z_t$. This can be done with a Newton solver with an update from step j to step $j + 1$ by

$$\begin{aligned} \ell_t^{j+1} &= \ell_t^j - \frac{f(\ell_t)}{f'(\ell_t)} \\ &= \ell_t^j - \frac{\ell_t - \left(\frac{(1 - \tau)w_t z_t}{\varphi} \right)^{\frac{1}{\nu}} c_t^{-\sigma/\nu}}{1 - \left(\frac{(1 - \tau)w_t z_t}{\varphi} \right)^{\frac{1}{\nu}} (-\sigma/\nu) c_t^{-\sigma/\nu - 1} \frac{\partial c_t}{\partial \ell_t}} \\ &= \ell_t^j - \frac{\ell_t - \left(\frac{(1 - \tau)w_t z_t}{\varphi} \right)^{\frac{1}{\nu}} c_t^{-\sigma/\nu}}{1 - \left(\frac{(1 - \tau)w_t z_t}{\varphi} \right)^{\frac{1}{\nu}} (-\sigma/\nu) c_t^{-\sigma/\nu - 1} (1 - \tau)w_t z_t} \end{aligned}$$