Fiscal Policy and the Distribution of Consumption Risk

M. M. Croce, T. T. Nguyen and L. Schmid

Abstract

Recent fiscal interventions have raised concerns about US public debt, future fiscal pressure, and long-run economic growth. In this paper, we study fiscal policy design when agents have recursive preferences and hence are averse to uncertainty about long-run growth prospects. In this setting, it is optimal to use fiscal instruments to smooth continuation utilities rather than consumption. When tax distortions affect future growth and hence continuation utilities, debt arises as a device to reallocate such distortions and, ultimately, consumption risk over time. In our quantitative work, we use asset prices to discipline aversion toward long-run uncertainty. We find that countercyclical tax policies promoting short-run stabilization financed through debt can substantially increase long-run uncertainty and reduce welfare. This suggests caution against tax smoothing inherent in many policy prescriptions.

Keywords: Fiscal Policy, Ramsey Taxation, Recursive Preferences, Endogenous Growth, Tax Smoothing

First Draft: February 2011. This Draft: May 2011

---

*We thank Andrew Abel, Urban Jermann, Amir Yaron, Nicholas Souleles for their specific comments. We also thank seminar participants at the Wharton School, the Federak Reserve Bank of Philadelphia and at the University of Minnesota.

†Mariano Massimiliano Croce is at the Kenan-Flagler Business School, UNC at Chapel Hill; Thien Nguyen is at the Wharton School, University of Pennsylvania; Lukas Schmid is at the Fuqua School of Business at Duke University.