ECON 815

Policy and the Lucas Critique

Winter 2014

Production with Labour and Capital

- firm hires workers n and pays wages w
- firm buys capital k at interest rate r
- Production function:

$$F(k, n) = Ak^{\alpha}n^{1-\alpha}$$

with $A > 0$ and $\alpha \in (0, 1)$.

This is a neoclassical production function.

- homogeneous of degree one – or CRS

$$F(\lambda k, \lambda n) = \lambda F(k, n) \text{ for all } \lambda > 0$$

- diminishing marginal products for all inputs
- Inada conditions
- for fixed labor input, decreasing returns to scale in capital

Optimal Production

Maximize Profits:

$$\max_{k,n} AF(k,n) - wn - rk$$

Solution:

$$\begin{aligned} \text{MPK} = F_k = A\alpha \left(\frac{k}{n}\right)^{\alpha-1} &= r \\ \text{MPL} = F_l = A(1-\alpha) \left(\frac{k}{n}\right)^{\alpha} &= w \end{aligned}$$

This implies zero profits.

The firm's output is just split between the inputs according to the factor shares α and $(1-\alpha)$.

Labour vs. Leisure Choice

Preferences are defined over two goods, consumption and leisure

$$U(c_1, 1-n_1) + \beta U(c_2, 1-n_2) = u(c_1) + v(1-n_1) + \beta(u(c_2) + v(1-n_2))$$

Endowments:

- time $n_1 \in (0,1)$
- time $n_2 \in (0,1)$
- capital k_1, which fully depreciates after production

Budget constraints – sequential:

$$\begin{aligned} c_1 + k_2 &\leq w_1 n_1 + r_1 k_1 \\ c_2 &\leq w_2 n_2 + r_2 k_2 \end{aligned}$$

Intertemporal budget constraint:

$$c_1 + \frac{c_2}{r_2} \leq w_1 n_1 + \frac{w_2 n_2}{r_2} + r_1 k_1$$

Solution

FOC:

$$\begin{aligned} \frac{u'(c_t)}{v'(1-n_t)} &= \frac{1}{w_t} \text{ for } t = 1, 2 \\ \frac{u'(c_1)}{\beta u'(c_2)} &= r_2 \end{aligned}$$

In terms of labour choice only, we get

$$\frac{v'(1-n_1)}{\beta v'(1-n_2)} = \left(\frac{w_1}{w_2}\right) r_2$$

Key Insight: How much people work depends on

- productivity today (w_1)
- (expected) productivity tomorrow (w_2)
- willingness to substitute leisure across time (r_2)

Taxes and Distortions

- labour income taxes: τ_1^n and τ_2^n
- capital income taxes: τ_1^k and τ_2^k

The budget constraints then become

$$\begin{aligned} c_1 + k_2 &\leq (1-\tau_1^n)w_1 n_1 + (1-\tau_1^k)r_1 k_1 \\ c_2 &\leq (1-\tau_2^n)w_2 n_2 + (1-\tau_2^k)r_2 k_2 \end{aligned}$$

Wedges in FOCs:

$$\begin{aligned} \frac{u'(c_t)}{v'(1-n_t)} &= \frac{1}{(1-\tau_t^n)w_t} \text{ for } t = 1, 2 \\ \frac{u'(c_1)}{\beta u'(c_2)} &= (1-\tau_2^k)r_2 \end{aligned}$$

Note that capital taxes in period 1 are lump-sum.

Analyzing Changes in Taxes ...

Some assumptions to make our life easier:

- production function is linear in labour: $f(n) = n$
- there is no investment, but people can save s at interest rate $1 + r$

The intertemporal budget constraint is then given by

$$c_1 + \frac{c_2}{1+r} \leq (1-\tau_1)w_1 n_1 + \frac{(1-\tau_2)w_2 n_2}{1+r}$$

Taxes are used to build pyramids G which are useless for anyone.

- $G = g_1 + g_2$.
- tax revenue is given by $T_1 = \tau_1 w_1 n_1$ and $T_2 = \tau_2 w_2 n_2$
- government budget constraint $g_t = \tau_t w_t n_t$

Question: What would be the effect on tax revenues (or output)?

... Is not so Straightforward!

Key Idea: People's decisions are not fixed.

They will react to changes in policy and anticipate future changes in policy.

In turn, when decisions change, equilibrium will also change.

The total change in revenue is given by

$$dT = \left(w_1 n_1 + \tau_1 w_1 \frac{\partial n_1(\tau_1, \tau_2^e)}{\partial \tau_1} + \tau_1 n_1 \frac{\partial w_1(\tau_1, \tau_2^e)}{\partial \tau_1} \right) d\tau_1$$

- the first term is the *tax base*
- the second term is how people's labour supply reacts to tax changes
- the third term is how tax changes will influence equilibrium wages
- the term τ_2^e stands for *expected future tax changes*

The Lucas Critique

1) Decision rules are not invariant to policy changes.

$\Longrightarrow$ We need to use the first-order condition $\frac{u'(c_1)}{v'(1-n_1)} = \frac{1}{(1-\tau_1)w_1}$.

2) People can forecast the effects of policy changes and will adjust their behaviour appropriately.

$\Longrightarrow$ To finance G, it must be the case that τ_2 increases – or, $\tau_2^e > \tau_2$.

3) There are feedback effects from individual decisions – or, general equilibrium effects.

$\Longrightarrow$ The equilibrium wage rate and output will change as people adjust their labour supply.

Conclusion: We need a structural model in order to be able to evaluate economic policy. The model has some structural parameters which are fixed, but people's decisions vary with economic policy.

Ricardian Equivalence

Suppose the government needs to consume g_1 in period 1 and g_2 in period 2.

It can raise taxes τ_t in both periods and borrow (or lend) b at rate $(1+r)$ in the first period.

Government budget constraints:

$$\begin{aligned} g_1 &= \tau_1 w_1 n_1 + b \\ g_2 &= \tau_2 w_2 n_2 - (1+r)b \end{aligned}$$

Theorem: Let $(c_1, c_2, n_1, n_2, (1+r))$ be an equilibrium for government policies $(g_1, g_2, \tau_1, \tau_2, b)$. Then the same allocation and prices are still an equilibrium for any policy $(g_1, g_2, \tilde{\tau}_1, \tilde{\tau}_2, \tilde{b})$ that satisfies the government's budget constraints.

In other words, the government's timing of taxation, and consequently, its debt policy is irrelevant as long as spending remains the same.

In equilibrium, we have

$$\begin{aligned} \frac{u'(c_1)}{\beta u'(c_2)} &= (1+r) \\ w_1 &= w_2 = 1 \\ c_1 &= n_1 - g_1 \\ c_2 &= n_2 - g_2 \end{aligned}$$

Hence, as long as the interest rate $(1+r)$ remains the same, the equilibrium remains the same.

Using the government's budget constraints, we have for people's budget constraints

$$\begin{aligned} c_1 + \frac{c_2}{1+r} &= (1-\tau_1)w_1 n_1 + \frac{(1-\tau_2)w_2 n_2}{1+r} \\ &= w_1 n_1 + g_1 + \frac{w_2 n_2 + g_2}{1+r} \\ &= n_1 + g_1 + \frac{n_2 + g_2}{1+r} \end{aligned}$$