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Thesis chapter 2

Michal Horvath <michal.horvath@york.ac.uk> 7 March 2019 at 15:45
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Hi Seyi

so I read this chapter. My comments are as follows:

- I would frame the introduction in the context of the broad literature on fiscal shocks rather than a narrow set of papers similar to your analysis. In particular, there is this paper and the related literature. It all goes back to Blanchard and Perotti and their discussion with Valerie Ramey which continues until today. There was this paper as well which spurred a small literature trying to find ways of generating a positive consumption response follow increases in G (there were those small papers by Linnemann and Schabert in that stream too). I think it is best to motivate this chapter this way. The literature generally concludes that output goes up following increases in G and there is a debate about the other variables. But Alesina and co have argued that it is possible to have expansionary austerity (or recessionary stimuli). They are arguing investment is a key channel. This paper presents a more nuanced view and highlights the role of investment in new products. Am I right that the BGM do not find this result? So the fact that new product creation is interacted with a matching friction must play a role too.
- There is an issue with the way the fiscal side is modelled. The government budget constraint seems to feature lump sum taxes. That constraint can then always be satisfied and there is no need for debt either. By the way, the debt - the way you have written it down - is state non-contingent. State-contingent debt would be an instrument whose return r depends on the state of the economy (ex ante).
- The fact that we have lump-sum taxes in there is fine but it is a special case. It kind of separates the effect of the fiscal shock from other policy feedbacks which are necessary if fiscal sustainability is meant to be satisfied in a stochastic model. People will ask about this - how is fiscal sustainability ensured in the model - and your answer is that it is through T but then the reviewer will say it is a special (unrealistic) case. Usually, there is also some kind of a feedback from higher debt into taxes which may or may not reinforce the result with lump-sum taxes. Have you tried something like that?
- In the text, you have "labour supply is absent" - which is what we discussed the other day. I think the correct thing is to say that there is no labour supply decision by the household but that the bargaining implies a labour supply schedule or something like that.
- new product creation is a key mechanism here, so there should be a detailed discussion of the decision in the model section. it is ok to cut bits short because the model is little changed relative to the one in the other chapters but you want to have the important details there, and in this case product creation seems important to undestand the intuition behind the result. so why do people invest more into new products when G goes up (and C falls, and investment into physical capital falls etc.) they obviously see greater returns from product creation in the future; so where do these greater profits come from?
- in part 4, you argue that the responses under different degrees of regulation are broadly similar, and so you continue discussing broad patterns only. but then in part 5, there is a whole section discussing the responses in different regulatory environments. I would probably say in part 4 that we discuss the broad patterns without emphasizing the similarity and then section 5 would concentrate on the key differences under different structural policies.

That's all I have here. Hope it helps.

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