Discussion of “Micro Risks and Pareto Improving Policies” by M Aguiar, M Amador, and C Arellano

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Summary – Assumptions

Setting: Bewley-Huggett-Aiyagari model with no wealth effects on labour supply.

Role of heterogeneity is limited: The **aggregate savings schedule is a sufficient statistic** for heterogeneity, only the elasticity of aggregate savings to interest rates matters.

The authors focus on the case $r < g = 0$.

The policy-maker has **5 instruments**: proportional taxes on capital and labour income and profits, debt, lump-sum transfer.

Summary – Research Question and Results

(Under what conditions) can the policy-maker achieve a ‘robust’ Pareto improvement (RPI) relative to the *laissez faire*?

Two conditions: $r_t \geq r_0$ and $T_t \geq 0$ (while wages and profits are unchanged). This implies that the budget sets of all households expand.

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Results:

1. Constant-K case: issue debt to finance T, r rises – this effect must be small for RPI. No change in macro variables, but better risk sharing.
2. Decrease capital ($F_K < \delta$ initially): issue debt and tax capital, keep $r_t = r_0$, $\forall t$.
3. Increase capital ($F_K > \delta$ initially): depends on savings elasticities, numerical results tell us debt and capital are complements.

Questions and comments

- Role of the 5 policy instruments? How do the Pareto-improving policies look?
- What should be the benchmark/status quo when we think about Pareto improvements?
- Relatedly, are there possible Pareto improvements relative to the Pareto-improving policies proposed?
- Who benefits from the policy change? Do we wish to favour the poor/unlucky?