Long-Run Fiscal Uncertainty, Growth and Asset Prices*

M. M. Croce, H. Kung and L. Schmid†

PRELIMINARY

Abstract

Following massive government interventions during the great recession of 2007-2009, governments’ indebtedness has skyrocketed around the globe. These dramatic financing needs raise uncertainty about the future stance of fiscal policies and their effects on the growth prospects of the economy. In this paper, we reconsider the link between short-run stabilization and uncertainty about long-term fiscal policies from an asset pricing perspective. Asset prices contain important information about both short-run fluctuations and long-term growth prospects. We analyze this information in a general equilibrium model with real and financial frictions that is consistent with both quantities and prices. Focusing on debt and persistent stochastic corporate tax rates as fiscal policy instruments, we first show that firms optimal response to tax shocks induces persistent swings in macroeconomic variables, which coupled with recursive preferences command high risk premia in asset markets. We then evaluate the welfare implications of simple fiscal policy rules linking government’s debt and corporate tax policies to the state of the economy. In models calibrated to match asset price data, we show that the welfare costs of countercyclical fiscal policies are positive and can be substantial.

First Draft: February 2010. This Draft: August 2010

*We thank David Backus, Ravi Bansal, Michael Brandt, João Gomes, Urban Jermann, Amir Yaron, Chris Parsons and seminar participants at Duke, UNC, CEPR 2010 summer meetings, and SED 2010 meetings for their comments.

†Mariano Massimiliano Croce is affiliated with the Kenan-Flagler Business School, UNC at Chapel Hill; Howard Kung and Lukas Schmid are at the Fuqua School of Business at Duke University.