Discussion of
“Optimal Monetary Policy with Redistribution”

La’O and Morrison (2025)

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Big picture

- **Conventional wisdom on monetary policy**:
  - If fiscal policy is sufficiently flexible, optimal MP stabilizes prices
    [Correia Nicolini Teles 2008]
  - If fiscal policy is not sufficiently flexible, optimal MP stabilizes the economy
    [Bhandari Evans Golosov Sargent 2021, Acharya Challe Dogra 2023]

- **This paper challenges conventional wisdom**:

  Optimal monetary policy makes output more volatile with redistribution concerns than without those considerations

What this paper is about

- **Business-cycle risk is systematically unequal**
  [Storesletten Telmer Yaron 2004, Parker Vissing Jorgensen 2009, Guvenen et al 2014, 2017]
  - Households differ *ex ante* in their exposure to aggregate fluctuations
  - Low-income households' earnings covary more strongly with output

    $\rightarrow$ Earnings inequality is countercyclical

- **Fiscal policy—the natural redistributive tool—is not flexible enough**
  - Tax rates don't adjust at business-cycle frequencies—monetary policy does

- **Main idea**:

  When inequality is cyclical and fiscal policy can't redistribute in real time, monetary policy can

What this paper does

- **Environment**: heterogeneous-agent, complete-markets, sticky-price economy
  - Households differ *ex ante* in state-contingent labor productivity $\theta^i(s_t)$

  → Complete markets kill ex-post insurance motive $\Longrightarrow$ only ex-ante heterogeneity
  model isolates redistributive motive for monetary policy

- **Ramsey planner**: maximizes a weighted sum of utilities subject to feasibility and implementability constraints, with:
  - Linear taxes $(\tau_c, \tau_\ell, \tau_r, \tau_\Pi)$: **non-state-contingent** and **uniform across types**
  - Lump-sum transfers $T(s_t)$: **state-contingent** but **uniform across types**
  - Monetary policy: **fully state-contingent**

- **Primal approach** (in the tradition of Lucas Stokey 1983 and Chari Kehoe 1999):
  Werning 2007 + Correia–Nicolini–Teles 2008 + Angeletos–La'O 2020

Main findings

1. **Under proportional skill shocks, optimal MP targets price stability**
   [no redistributive role for monetary policy]
   - All redistribution via the tax system (constant linear labor tax = Werning's optimum)

2. **Under relative skill shocks, optimal MP targets a state-contingent markup**
   [redistributive role for monetary policy]
   - Tax system alone is insufficient—MP substitutes for missing fiscal instrument
   - Markup acts as an *implicit, state-contingent labor tax*
     [$\mathcal{M}^*(s_t)$ is increasing in $\mathcal{I}(s_t)$, a sufficient statistic for labor-income inequality]

3. **Model calibration to Guvenen et al's worker betas**:
   - Countercyclical inequality $\Longrightarrow$ countercyclical markup

   $\rightarrow$ **Optimal MP targets countercyclical markup and is output-destabilizing**

Why this paper is important

1. Policy prescriptions challenge conventional wisdom: optimal MP makes output more volatile with redistribution concerns than without them
   - Bhandari et al 2021: with incomplete mkts, insurance dominates, MP stabilizes
   - La'O–Morrison: with complete markets & no insurance motive, MP destabilizes
2. Extends Werning 2007 (optimal FP with redistribution) to monetary policy
   - Werning: optimal linear labor taxation under ex-ante heterogeneity
   - La'O–Morrison: when tax rates can't adjust at business-cycle frequencies, MP can fill the role that optimal state-contingent linear labor taxes play in Werning
3. Takeaway: cyclicality of inequality should be a state variable for monetary policy when monetary authority has redistributive concerns

My Discussion

My discussion

- Great paper: learned a lot + pleasure to read (very clear, beautifully written!)
- Two points:
  1. Will argue fiscal policy is very flexible in practice
  2. Will argue that some implications of the model are inconsistent with the data

Point 1: Fiscal policy is very flexible in practice

- **Fiscal policy responds very fast when shocks are large**
  - 2008–09 financial crisis: 2–3 weeks from shock to first legislation
    [EESA Oct 2008; ARRA Feb 2009: UI extensions, marginal tax cuts for poor, $800B stimulus]
  - COVID-19 (2020): extraordinarily fast, 1–2 weeks
    [CARES Act, Mar 2020: $2.2T, expanded UI, rebates, PPP]

+ **Automatic stabilizers don't require legislative action at all**
  - Progressive tax, EITC, SNAP, UI, Medicaid expand in downturns automatically

- **For small shocks, FP may indeed be slow**—but redistributive concerns small

→ Case for redistributive MP depends on FP being sluggish and incomplete

Point 1 (cont'd): Automatic stabilizers already redistribute

- The previous slide was an empirical point. **I now formalize the redistributive role of one automatic stabilizer: progressive labor income taxation**

1. **Progressive labor income tax**—HSV form, $\varphi > 0$ [τ_ℓ and φ non-state-contingent]:

$$y^i(s^t) = (1-\tau_\ell)\left[W(s^t)\,\ell^i(s^t)\right]^{1-\varphi}, \qquad \ell^i(s^t) \equiv \theta^i(s_t)\,h^i(s^t)$$

$$\Longrightarrow \qquad \Delta \log\left(y^H/y^L\right) = (1-\varphi)\cdot \Delta \log\left(\frac{\theta^H(s_t)h^H(s^t)}{\theta^L(s_t)h^L(s^t)}\right)$$

Progressivity compresses relative earnings before MP enters
[HSV's calibration for US puts this number roughly at 20%]

→ **Non-state contingent progressivity mechanically offsets relative skill shocks**

2. **Type-specific transfers $T_i(s^t)$ reinforce this logic**: redistribute directly across types and states [EITC, SNAP, Medicaid, UI, etc. do some of this in practice]

Point 2: countercyclical labor wedge $\neq$ countercyclical markup

- Point 2: Should monetary policy destabilize via countercyclical markup?
  - a) In the paper's calibrated model, it is optimal
    1. Countercyclical earnings ineq. $\Longrightarrow$ planner wants more redistribution in recessions
    2. With restricted fiscal instruments, redistribution is implemented through countercyclical labor wedge—an implicit *state-contingent* tax on labor income
       [Lower W + uniform $T \Longrightarrow$ high-θ households lose more in dollars]
    3. In La'O–Morrison, the labor wedge is: See derivation

$$\underbrace{\frac{\text{MPL}(s^t)}{\text{MRS}(s^t)}}_{\text{labor wedge}} = \underbrace{\frac{\text{MPL}(s^t)}{W(s^t)/P(s^t)}}_{=\mathcal{M}(s^t)} \times \underbrace{\frac{W(s^t)/P(s^t)}{\text{MRS}(s^t)}}_{=(1+\tau_c)/(1-\tau_\ell)} = \mathcal{M}(s^t) \times \frac{1+\tau_c}{1-\tau_\ell}$$

$\Longrightarrow$ optimal MP targets a countercyclical markup $\mathcal{M}^*(s^t)$ and destabilizes output

Point 2: countercyclical labor wedge $\neq$ countercyclical markup

- Point 2: Should monetary policy destabilize via countercyclical markup?
  - a) In the paper's calibrated model, it is optimal
  - b) But the key model mapping (labor wedge = markup) is not supported in data!
    - HH component explains $\approx$ 85% of cyclical variation in US labor wedge [Karabarbounis 2014] ▸ See evidence
    - Firm component (markup) explains $\approx 2\%$, and is procyclical [Karabarbounis 2014, Hasenzagl Perez 2026, Anderson Rebelo Wong 2020] ▸ See evidence

$\rightarrow$ Theorem 1 is internally valid, but it assigns the redistributive role to a margin (firm component) that does not drive labor-wedge cyclicality in the data

Point 2: countercyclical labor wedge $\neq$ countercyclical markup

- Point 2: Should monetary policy destabilize via countercyclical markup?
  - a) In the paper's calibrated model, it is optimal
  - b) But the key model mapping (labor wedge $=$ markup) is not supported in data!
    [HH component explains $\approx$ 85% of cyclical variation in US labor wedge; firm side $\approx$ 2%]
  - c) Authors claim that results are robust to nature of nominal rigidities, but only formalize sticky P + flex W. Would be nice to see this formalized!
    - Flipping the rigidity (sticky W + flex P) would make the model match the data: cyclical labor-wedge variation moves to HH side ▸ See labor wedge
    - Speculation: redistribution becomes more costly under sticky W
      [**Paper**: redistribute via $\mathcal{M}$ vs. **price dispersion** (small)]
      [**Sticky W**: redistribute via HH wedge vs. **employment distortion** (typically larger)]

$\rightarrow$ Even if MP serves no insurance motive, the case for destabilizing the economy may be weaker than the model suggests

My Take

My take

- La'O–Morrison make an important point, challenging conventional wisdom
  - **Conventional wisdom**: If FP is not sufficiently flexible, optimal MP stabilizes
  - **La'O–Morrison**: *Optimal MP makes output more volatile with redistribution*
- My discussion:
  1. **Is fiscal policy really that inflexible?** Empirical evidence suggests not so much
  2. **Is the markup the relevant margin?** Empirical evidence suggests not
     - Details matter: aligning model's mechanism with data may alter policy
- **Bottom line**. In line with the authors: MP can have redistributive effects, but *it may be difficult to achieve distributional aims with monetary policy*

Questions?

Thank You!

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Appendix

Labor wedge: derivation

- **Labor wedge**: the gap between the MPL and the MRS

$$\underbrace{\exp(\omega_\ell(s^t))}_{\text{labor wedge}} := \frac{\text{MPL}(s^t)}{\text{MRS}(s^t)} = \underbrace{\frac{\text{MPL}(s^t)}{W(s^t)/P(s^t)}}_{\substack{\text{firm component} \\ \exp(\omega_\ell^f(s^t))}} \times \underbrace{\frac{W(s^t)/P(s^t)}{\text{MRS}(s^t)}}_{\substack{\text{household component} \\ \exp(\omega_\ell^h(s^t))}}$$

- **Production side in La'O–Morrison**: $\text{MPL}(s^t) = A(s_t)$

$$Y(s^t) = \left[\int_{j\in\mathcal{J}} y^j(s^t)^{\frac{\rho-1}{\rho}}\right]^{\frac{\rho}{\rho-1}}, \quad y^j(s^t) = A(s_t)\ell^j(s^t) \qquad \Longrightarrow \qquad Y(s^t) = A(s_t)L(s^t)$$

- **Nominal MC is $W(s^t)/A(s_t)$, so the markup is $\mathcal{M}(s^t) = P(s^t)A(s_t)/W(s^t)$**

- **Firm component of the labor wedge**:

$$\exp(\omega_\ell^f(s^t)) = \frac{\text{MPL}(s^t)}{W(s^t)/P(s^t)} = \mathcal{M}(s^t) \qquad \Longleftrightarrow \qquad \omega_\ell^f(s^t) = \log \mathcal{M}(s^t)$$

Labor wedge: derivation

- Household side in La'O–Morrison: $\text{MRS} = c^{\gamma} h^{\eta}$

$$U(c,h) = \frac{c^{1-\gamma}}{1-\gamma} - \frac{h^{1+\eta}}{1+\eta} \qquad \Longrightarrow \qquad \text{MRS}(s^t) = c(s^t)^{\gamma} h(s^t)^{\eta}$$

- Household component of the labor wedge:

$$\exp(\omega_{\ell}^{h}(s^t)) = \frac{W(s^t)/P(s^t)}{\text{MRS}(s^t)} = \frac{1+\tau_c}{1-\tau_{\ell}} \qquad \Longleftrightarrow \qquad \omega_{\ell}^{h}(s^t) = \log\left(\frac{1+\tau_c}{1-\tau_{\ell}}\right)$$

- In La'O–Morrison, the labor wedge is:

$$\exp(\omega_{\ell}(s^t)) = \frac{\text{MPL}(s^t)}{\text{MRS}(s^t)} = \mathcal{M}(s^t) \times \frac{1+\tau_c}{1-\tau_{\ell}} \qquad \Longleftrightarrow \qquad \omega_{\ell}(s^t) = \log \mathcal{M}(s^t) + \log\left(\frac{1+\tau_c}{1-\tau_{\ell}}\right)$$

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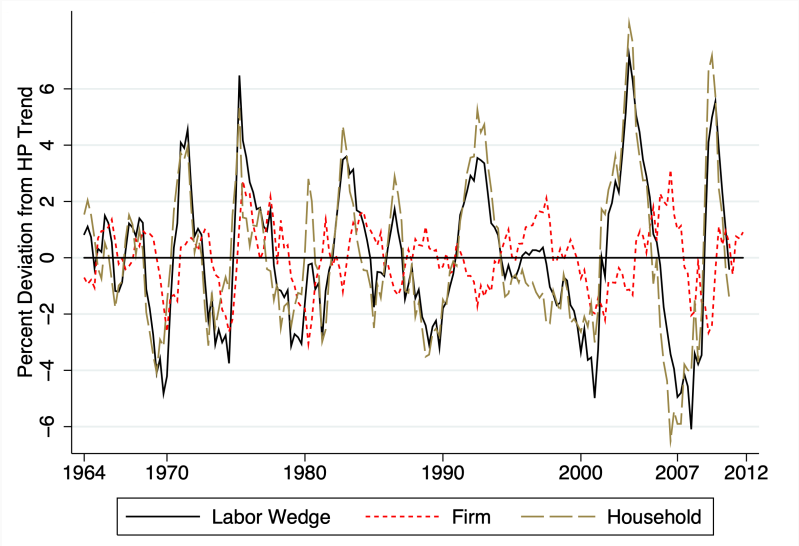
US labor wedge: cyclicality decomposition [Karabarbounis 2014]



Labor wedge: cyclicality decomposition [Karabarbounis 2014, Table 8 (HP filter)]

	OECD Unadjusted		OECD Adjusted		KLEMS Unadjusted		KLEMS Adjusted		Average	
Country	Firm	Household	Firm	Household	Firm	Household	Firm	Household	Firm	Household
Australia	1.30	57.21	8.82	75.75	10.09	72.37	0.62	79.16	5.21	71.12
Austria	27.83	42.30	23.97	11.45	32.31	61.10	35.88	64.19	29.99	44.76
Canada	4.05	72.75	0.07	63.34	—	—	—	—	2.06	68.05
Finland	2.17	62.61	3.50	58.90	4.29	70.61	5.66	68.10	3.91	65.06
France	4.14	83.57	0.18	70.69	6.74	85.98	1.12	82.26	3.05	80.63
Germany	24.01	40.33	27.90	36.64	24.29	58.10	19.59	61.14	23.95	49.05
Ireland	1.78	78.36	0.32	59.07	0.98	73.21	0.08	78.45	0.79	72.27
Italy	9.25	75.49	22.08	75.43	21.91	76.10	18.30	74.49	17.89	75.38
Japan	6.66	70.98	1.41	58.53	6.73	66.90	4.20	67.49	4.75	65.98
Korea	6.51	90.07	19.86	86.06	30.21	86.42	13.96	84.67	17.64	86.81
Norway	12.64	17.38	17.78	8.66	—	—	—	—	15.21	13.02
Spain	15.81	95.52	1.01	98.24	0.20	58.44	0.10	59.67	4.28	77.97
Sweden	0.49	30.28	13.62	78.57	14.49	79.12	16.88	79.94	11.37	66.98
United Kingdom	7.70	45.33	9.99	47.38	13.37	39.64	17.08	41.02	12.04	43.34
United States	3.00	88.04	0.09	90.69	2.00	79.30	0.55	80.54	**1.41**	**84.64**

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Labor wedge: cyclicality of the firm component [Karabarbounis 2014, Table 10]

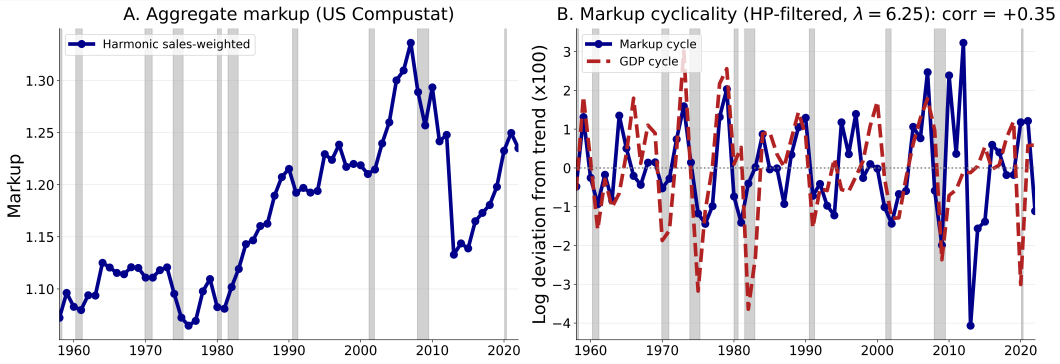
▶ Karabarbounis 2014 documents firm component of labor wedge is procyclical

	OECD Unadjusted		OECD Adjusted		KLEMS Unadjusted		KLEMS Adjusted	
Country	HP Filter	BK Filter	HP Filter	BK Filter	HP Filter	BK Filter	HP Filter	BK Filter
Australia	0.26	0.26	0.33	0.38	0.40	0.45	0.41	0.47
Austria	0.60	0.56	0.56	0.51	0.50	0.61	0.41	0.56
Finland	0.48	0.41	0.51	0.43	0.24	0.25	0.33	0.33
France	0.56	0.47	0.65	0.61	0.35	0.24	0.24	0.27
Germany	0.45	0.26	0.44	0.24	-0.04	-0.03	0.07	0.04
Ireland	0.38	0.39	0.40	0.49	0.22	0.28	0.15	0.25
Italy	0.38	0.33	0.53	0.49	0.46	0.43	0.57	0.57
Japan	0.77	0.75	0.02	0.00	0.63	0.44	0.62	0.44
Korea	0.01	-0.01	0.00	-0.04	-0.41	-0.37	-0.06	-0.03
Spain	-0.01	0.06	0.02	0.07	-0.21	-0.10	-0.09	-0.01
Sweden	0.59	0.39	0.39	0.31	0.19	0.18	0.15	0.15
United Kingdom	0.55	0.50	0.54	0.52	0.48	0.51	0.46	0.50
United States	0.23	0.25	0.30	0.36	0.19	0.22	**0.28**	**0.31**

Cyclicality of the firm component of the labor wedge + markup cyclicality

- Karabarbounis 2014 documents firm component of labor wedge is procyclical
- Hasenzagl Perez 2026 (MAPS) find US markup is procyclical (Compustat) Back

  [in line with Anderson Rebelo Wong 2020 and Nekarda Ramey 2020]



Labor wedge derivation: flexible prices and sticky wages

- **Firm pricing under flexible prices**
  - Monopolistic competition: $P(s^t) = \mathcal{M}(s^t) \cdot MC(s^t)$
  - Flexible prices $\Longrightarrow$ markup is constant: $\overline{\mathcal{M}}^* = \rho/(\rho - 1)$

- **Household side with sticky nominal wages**: $W(s^t) = W^*(s^{t-1})$
  - At sticky $W^*(s^{t-1})$, workers off labor supply curve: $\text{MRS}(s^t) \neq W^*(s^{t-1})/P(s^t)$

    $\rightarrow$ Household component of labor wedge is **time-varying** and **distinct from 1**

- **Labor-wedge decomposition** $\rightarrow$ **All cyclical variation comes from HH side**

$$\underbrace{\frac{\text{MPL}(s^t)}{\text{MRS}(s^t)}}_{\text{labor wedge}} = \underbrace{\frac{\text{MPL}(s^t)}{W^*(s^{t-1})/P(s^t)}}_{\substack{\text{firm component} \\ = \overline{\mathcal{M}}^* \text{ (constant)}}} \times \underbrace{\frac{W^*(s^{t-1})/P(s^t)}{\text{MRS}(s^t)}}_{\substack{\text{HH component} \\ \text{(cyclical)}}}$$

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