

# Smooth Diagnostic Expectations\*

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September 2024

## Abstract

We show that the formalization of representativeness (Kahneman and Tversky (1972)) developed by Gennaioli and Shleifer (2010) features an intrinsic connection between *uncertainty* and *overreaction*. In the time series domain, we develop this connection in a *smooth* version of Diagnostic Expectations (DE). Intuitively, under smoothness, when uncertainty is low there is less room for representativeness to distort beliefs. Smooth DE implies a joint and parsimonious micro-foundation for key properties of survey data: overreaction to news, stronger overreaction for longer forecast horizons, overconfidence in subjective uncertainty, and a new stylized fact documented in this paper, namely that overreaction is stronger when uncertainty is high. An analytical Real Business Cycle model featuring Smooth DE accounts for overreaction and overconfidence in surveys, as well as three salient properties of the business cycle: asymmetry, countercyclical micro volatility, and countercyclical macro volatility.

JEL Codes: D91, E32, E71.

Keywords: Diagnostic expectations, uncertainty, learning, overreaction, overconfidence

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# 1 Introduction

There has been a growing interest in psychological foundations that enrich models of belief formation in Economics. A prominent example is the paradigm of Diagnostic Expectations (DE), developed by Gennaioli and Shleifer (2010) and Bordalo et al. (2016), that formalizes the widely-documented “representativeness heuristic” of Kahneman and Tversky (1972). According to this heuristic, agents’ subjective forecasts overreact to new information because memory selectively recalls more vividly past events that are more associated with, or representative of, that current news.<sup>1</sup>

In this paper, we emphasize and characterize the deep and pervasive relation between representativeness and uncertainty and study the theoretical and empirical implications of this relation. Specifically, we show how representativeness implies that the distance between the subjective distorted distribution and its objective counterpart depends on both the amount of information received (a *news channel*) and the precision of such information (an *uncertainty channel*). Intuitively, when uncertainty is low there is less room for belief distortions. Uncertainty affects the strength of the representativeness distortion and leads to variation in overreaction and confidence, accommodating both cases of under- and overconfidence.

We first illustrate the connection between representativeness and uncertainty in a static, two-state example. We then build on the insights of the static environment to argue that in the time series domain this connection manifests itself in a “smoothed” version of DE. In contrast to the standard DE modeling in the literature, under Smooth Diagnostic Expectations (Smooth DE), overreaction and confidence depend on conditional uncertainty. Finally, we study how Smooth DE provides a joint and parsimonious micro-foundation for key properties of survey data and of the business cycle. As a result, Smooth DE connects two vastly popular branches of Economics that have largely proceeded in parallel: the Diagnostic Expectations literature and the Uncertainty literature (Bloom (2009, 2014), Fernández-Villaverde et al. (2015), Basu and Bundick (2017), Bloom et al. (2018), Baker et al. (2024)), while at the same time contributing to a nascent literature that embeds DE in micro-founded macro models (Bianchi et al. (2024), L’Huillier et al. (2024), Bordalo et al. (2024), Na and Yoo (2024)).

**Representativeness and Uncertainty.** We first study the relation between uncertainty and representativeness in the classic example of inferring the probability of someone having red hair. In this example, representativeness implies that if the person of interest is revealed to be Irish, agents overreact and tend to overstate the probability that the person has red hair. This is because red hair is more representative of the Irish population with respect to the

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<sup>1</sup>Bordalo et al. (2022) provides an overview of DE modeling and related evidence. See Taubinsky et al. (2024) as recent evidence on overreaction in agents’ subjective forecasts, uncovering a key role for selective and associative memory recall.

world population. We use this example to emphasize that the strength of the overreaction is not monotonic, but rather hump-shaped. This is because two channels are at work: A *news channel*, measured by the distance between the current and reference distribution, and an *uncertainty channel*, measured by the entropy of the current distribution.

Suppose that there are only two categories - *red* and *non-red* hair color - and that, before any information is revealed about the particular person, the hair color red has a low probability. As information is revealed that makes the red hair more likely (say, Irish nationality), overreaction initially increases with the conditional probability assigned to the color red. This is because initially the news effect and the uncertainty effect work in the same direction: the color red is more likely *and* there is more uncertainty on the hair color, as an ex-ante low-probability hair color became more likely, but not certain. However, if the new information makes the objective probability cross the point of maximum uncertainty (50:50 in a two-state categorical distribution), the uncertainty effect starts working in the opposite direction. There is now progressively less uncertainty on the hair color and the distance between subjective and objective distributions declines. In the limit, when the probability of red hair goes to 1, uncertainty is fully removed, the uncertainty channel dominates the news channel, and the subjective and objective distribution coincide.

This interaction between the two channels also generate variation in the level of confidence. For small increases in the probability of the color red, the less likely hair color, the distorted distribution features more uncertainty than the objective distribution because, by overreacting, agents bring the perceived distorted probability closer to the point of maximum uncertainty (50:50). Eventually, overconfidence emerges, as agents’ overreaction leads to attribute more than .5 probability to the color red even if the objective distribution has not crossed the point of maximum uncertainty. As the probability of the hair color red approaches 1, the severity of overconfidence starts declining and eventually goes to zero.

**Smooth Diagnostic Expectations.** The natural adaptation of representativeness to the time series domain involves a “smoothed” version of DE. Under Smooth DE overreaction and confidence depend on conditional uncertainty, in a way similar to what we documented for categorical distributions. Agents overreact to new information, defined as the difference between the current information set and a previous information set. Since new information typically changes not just the conditional mean, but *also* the conditional uncertainty, changes in uncertainty surrounding current and past beliefs affect the extent of the DE distortion.

Smooth DE stems from a minimal, but conceptually important change to the baseline DE paradigm developed by Bordalo et al. (2018) (BGS) and it aligns well with the original “representativeness heuristic” of Kahneman and Tversky (1972). In the BGS formulation of DE, the reference distribution is centered on the conditional mean under the true density

formed at some given past time, but shares the same uncertainty as the true distribution conditional on current information. Instead, since we condition exclusively on the past information set, the reference distribution reflects the level of uncertainty at that past time. This is in line with the original formalization of representativeness developed by Gennaioli and Shleifer (2010) and Bordalo et al. (2016) for categorical distributions, in which information sets between current and reference distributions are kept distinct.

When the current and reference distributions are Normal, the baseline BGS formulation delivers a distorted distribution that is also Normal, but in which only the mean is affected by DE. In comparison, under Smooth DE we uncover two key novel properties of the distorted distribution. First, the severity of the Smooth DE distortion decreases as the current level of uncertainty decreases compared to past uncertainty. Put differently, we obtain a smooth version of the logic expressed by Gennaioli and Shleifer (2010), as now an agent is less prone to overreact to the new information the more precise the current information is with respect to past information. In the limit, as uncertainty is fully resolved by the new information, the distortion vanishes, as in the baseline DE. However, with Smooth DE, the extent of the distortion varies smoothly as current uncertainty increases with respect to past uncertainty, while the baseline DE features a discontinuity once current uncertainty goes to zero.

Second, Smooth DE delivers a disconnect between the *objective* and *subjective* level of uncertainty. This is because under Smooth DE, not only the mean, but also the variance of the DE distribution is distorted. When agents experience a reduction in uncertainty with respect to the reference distribution, agents over-state the precision of their forecasts, leading to *overconfidence*. In other words, in that case the DE distribution features a variance lower than under Rational Expectations (RE). Given that typically events close in the future are easier to predict than events far into the future, agents' beliefs will typically feature such overconfidence. However, the Smooth DE paradigm can also accommodate *underconfidence* following an increase in uncertainty, like in response to an uncertainty shock (Bloom (2009)).

Smooth DE is built on the key informational difference between conditional (posterior) and unconditional (prior) distribution. In this sense, our approach relates to Bordalo et al. (2020), which features a sampling by similarity framework that under conditional probability assessments yields a result reminiscent of DE. In that setting, the entire prior distribution plays a major role in memory interference. The shape of the prior distribution also affects the degree of overreaction in the finite-state framework and evidence presented in Ba et al. (2022). In that study, overreaction to signals decreases with their informativeness, consistent with the logic of Smooth DE. Closest to our setting, a version of what we label Smooth DE appears in chapter 5 of Gennaioli and Shleifer (2018). However, despite this early appearance, the growing DE literature has focused on the simplified version proposed in BGS.

**A parsimonious micro-foundation for survey evidence.** As the traditional DE, Smooth DE is characterized by a primitive stochastic environment and two parameters controlling (i) the severity of the distortion,  $\theta > 0$ , and (ii) the lag of the reference distribution,  $J \geq 1$ . Thus, Smooth DE makes use of *no additional* degree of freedom. Under Smooth DE, the primitive parameter  $\theta > 0$  measures the severity of the DE distortion for a *given* level of relative uncertainty, while the *effective* severity changes with the relative uncertainty.

We use the Survey of Professional Forecasters (SPF) to provide new evidence and test the Smooth DE’s basic implication that overreaction of forecasts to news is stronger in times of high uncertainty. In doing so, we follow Bordalo et al. (2020) and study the correlation between forecast revisions and the subsequent forecast errors. Our key novel empirical finding supports the basic Smooth DE prediction: at the individual level the overreaction to news is indeed stronger when uncertainty is higher. To connect with these novel findings, we then extend the signal-extraction setting in Bordalo et al. (2020) to allow for time-varying uncertainty within our Smooth DE framework.

Smooth DE is also consistent with other stylized survey facts. First, overreaction to news increases with the horizon of the survey forecast (see for example Bordalo et al. (2019), d’Arienzo (2020), Bordalo et al. (2020), Augenblick et al. (2021), and Bordalo et al. (2023)). Under Smooth DE, the same piece of information reduces uncertainty by less for longer horizons, leading to stronger overreaction. Second, recent work also documents that in survey data firms (i) *overreact* to news and (ii) are *overconfident* in their subjective forecasts (Barrero (2022), Born et al. (2022), Altig et al. (2020) and Born et al. (2022)). While the baseline DE model can account for overreaction, it is silent on overconfidence. Smooth DE can instead account for both properties since it distorts both the mean and the variance of agents’ expectations in a way to typically generate both overreaction and overconfidence.

**Business cycle implications.** We leverage our theoretical insights to study a parsimonious business cycle model with *time-varying uncertainty* to illustrate how state-dependent overreaction from Smooth DE generate important cyclical implications. We consider an island economy subject to economy-wide and island-specific TFP shocks. Following Bloom et al. (2018), we assume that the island-specific TFP shocks are subject to time-varying volatility that is negatively correlated with economy-wide TFP innovations. We show that this parsimonious model can account for Barrero (2022)’s survey evidence on overreaction and overconfidence, as well as three key empirical properties of the business cycle: (1) *asymmetry* (recessions are sharper than expansions), (2) *countercyclical micro volatility* (cross-sectional variances of microeconomic variables rise in recessions), and (3) *countercyclical macro volatility* (time-series variances of macroeconomic variables rise in recessions).<sup>2</sup>

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<sup>2</sup>These properties have been extensively documented in the literature. For instance, Neftci (1984), Hamil-

First, consider the asymmetry property. A negative economy-wide TFP shock generates higher uncertainty. Hence, agents overreact to the economy-wide TFP shock more than usual, leading to a sharper fall in hours, consumption, and output. In contrast, a positive TFP shock reduces agents' uncertainty, and the rise in economic activity is mild. Second, consider countercyclical micro volatility. In recessions, agents face higher uncertainty, so they overreact to the island-specific TFP and, as a result, the cross-sectional variances of island-level hours, output, and consumption increase. Conversely, during expansions, agents' overreactions are milder, and hence the cross-sectional dispersion decreases. Third, consider countercyclical macro volatility. The state-dependent overreaction implies that in recessions, economic activity responds strongly to an economy-wide shock to TFP, while in expansions the responses are more muted. As a result, the aggregate volatility rises in recessions even when there is no change in the volatility of economy-wide shocks. These mechanisms highlight that the micro-level uncertainty and macroeconomic volatility are tightly linked through the agent's state-dependent overreaction. As a result, a novel policy implication emerges: a redistributive policy that reduces idiosyncratic uncertainty could be beneficial for macroeconomic stabilization because it dampens the state-dependent overreaction.

## 2 Representativeness and uncertainty

The building block for Smooth DE is the concept of representativeness. Here we directly use the definition of representativeness introduced in recent work on selective memory by Gennaioli and Shleifer (2010), Bordalo et al. (2016, 2020). This definition, detailed below, captures formally Tversky and Kahneman (1975) own definition of representativeness: “an attribute is representative of a class if it is very diagnostic; that is, the relative frequency of this attribute is much higher in that class than in a relevant reference class” (p. 296).

To understand how we later build on this definition in the time series domain, we first consider a simple probability environment that is static and discrete. These examples illustrate how representativeness implies that overreaction to the relative frequency is shaped by the entire distribution of attributes, both in the class of interest and in the relevant reference class, consistently with the above definition by Tversky and Kahneman (1975). We highlight how the amount of *uncertainty* characterizing these distributions is of particular importance in shaping the effective manifestation of representativeness. This focus on the role of uncertainty will allow us to draw an explicit connection between the building block of representativeness and Smooth DE as developed in Section 3.

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ton (1989), McKay and Reis (2008), and Morley and Piger (2012) show macroeconomic asymmetries using various econometric approaches. Bloom (2009), Fernández-Villaverde et al. (2011), Ilut et al. (2018), Jurado et al. (2015), Basu and Bundick (2017), and Bloom et al. (2018) document that volatility or uncertainty rise in recessions at the micro and macro levels.

**Representativeness.** Consider a discrete probability space  $(\Phi, P)$ , with two random variables:  $X$ , the trait that the agent seeks to assess, and  $D$ , the available data. The agent looks to form the conditional probability of a given trait  $\hat{x} \in X$ , given a particular realized data  $d \in D$ . A Bayesian agent would simply use the conditional probability  $P(\hat{x}|d) = P(\hat{x} \cap d)/P(d)$ . The environment here is static, without a sense of repeated accumulation of information.

In assessing conditional probabilities, the agent subject to the representativeness heuristic distorts the Bayesian belief. Here we follow the formalization of representativeness in Gennaioli and Shleifer (2010), Bordalo et al. (2016, 2020). This work explains in detail how representativeness can be intuitively understood as the tendency to overweight representative traits, arising due to limited memory and the fact that representative traits are easier to recall. Formally, the representativeness of a given trait  $\hat{x}$  conditional on a particular data realization  $d$  compared to reference data,  $d^{ref}$ , is defined as the relative frequency of that trait across the two data groups:

$$rep(\hat{x}|d, d^{ref}) \equiv \frac{P(\hat{x}|d)}{P(\hat{x}|d^{ref})} \quad (1)$$

The conditional belief under representativeness is affected by a weight that distorts the underlying absolute frequency of  $\hat{x}$  conditional on the data  $d$

$$P^\theta(\hat{x}|d, d^{ref}) = P(\hat{x}|d) weight(\hat{x}|d, d^{ref}). \quad (2)$$

The weight reflects the effect of the relative frequency in equation (1), and is given by

$$weight(\hat{x}|d, d^{ref}) = [rep(\hat{x}|d, d^{ref})]^\theta / Z(d, d^{ref}). \quad (3)$$

with  $Z(d, d^{ref})$  a constant of integration such that the distribution integrates to one:

$$Z(d, d^{ref}) = \sum_{\hat{x} \in X} P(\hat{x}|d) [rep(\hat{x}|d, d^{ref})]^\theta \quad (4)$$

The parameter  $\theta \geq 0$  measures the extent to which the relative frequency across two conditioning data groups affects judgements. When  $\theta = 0$ , agent's memory retrieval is perfect and beliefs collapse to the standard frictionless model. When  $\theta > 0$ , memory is limited and agent's judgments are shaped by representativeness.

**Illustrations.** Our simple illustrations below let  $\Phi$  be the universe of people,  $X$  be different hair colors, and  $d \in D$  take on specific Nationality, with one of them being a reference

$d^{ref} = \{World\}$ .<sup>3</sup> We evaluate the effects of representativeness of the event  $\hat{x}$  conditional on a specific Nationality group, compared to the reference group  $d^{ref}$ .

## 2.1 Two-state distribution

Consider the case where  $X$  assume only two values, “red” or “non-red/other”, which we denote as  $\hat{x} = R$  and  $\hat{x} = NR$ , respectively. The agent observes the nationality of an unknown individual and assess the probability of the hair color red based on  $P^\theta(\hat{x} = R|Nationality, World)$  as defined in equation (2). In particular, the agent twists the underlying probability  $P(\hat{x} = R|Nationality)$  by *weight*  $(\hat{x} = R|Nationality, World)$  defined by equations (3) and (4). We are interested in how the distorted probability *distribution* and its distance (appropriately defined) from the actual conditional distribution depend on the underlying probability distributions. We emphasize the following *three qualitative properties*.

1. **Overreaction.** The distorted probability amplifies the relative change in frequency. This first and most immediate characteristic of representativeness can be immediately seen by equation (2). We show it graphically in Figure 1 (a.1), where we plot the distorted  $P^\theta(\hat{x} = R|Nationality, World)$  for different values of  $P(\hat{x} = R|Nationality)$  and diagnosticity parameter values  $\theta = 1, 2$ , as well as  $\theta = 0$  corresponding to no memory distortion. The frequency under the reference data is  $P(\hat{x} = R|World) = 0.2$ , marked by a vertical red dotted line. When the frequency of red hair for a given Nationality is higher (lower) than under the reference data, the distorted probability is higher (lower) than the actual frequency for that Nationality. The magnitude of the difference is increasing in  $\theta$ .

2. **News and uncertainty.** Representativeness is characterized by an effective degree of overreaction that is a function of the entire shape of the distributions for the two data groups that get compared. This property has typically been outside the main interest of recent applied work on representativeness and diagnostic expectations.<sup>4</sup> However, it will play an important role in our development of Smooth DE.

We separate two channels that create this relation between overreaction and the amount of information present in the conditional distributions that get compared. On the one hand, equation (3) features a *news effect*. When the knowledge of the Nationality implies a larger revision in the frequency of red hair, the representativeness  $rep(\hat{x} = R|Nationality, World)$  changes by more. Holding fixed the constant of integration  $Z(Nationality, World)$  in equa-

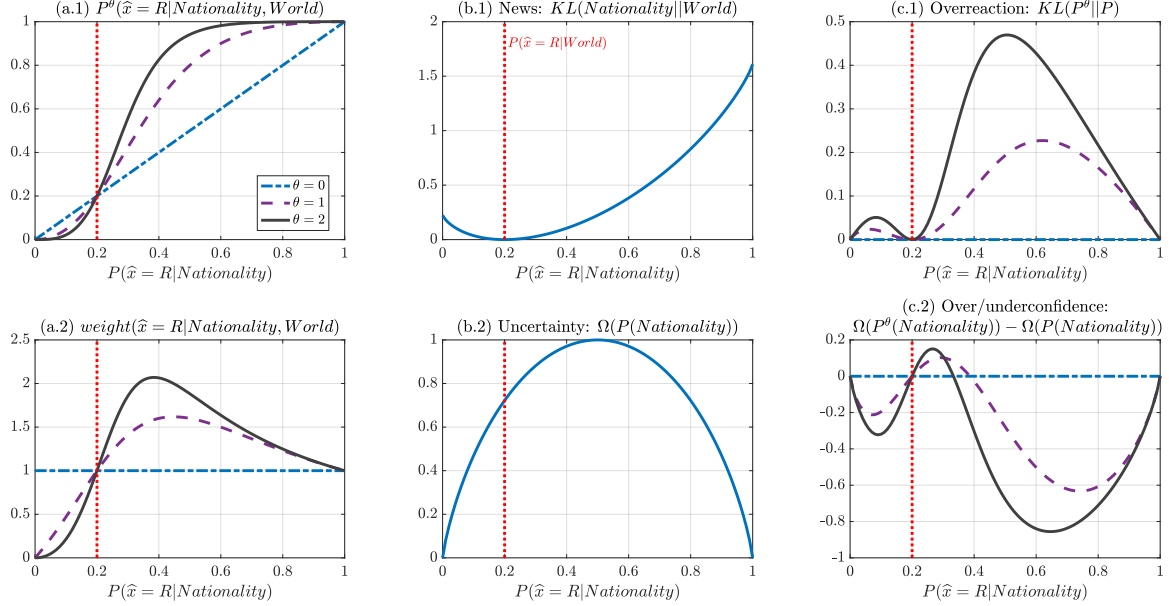
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<sup>3</sup>The particular numbers we will use are simply chosen to illustrate a series of key features of representativeness and are not necessarily reflecting the actual incidence of the hair colors in the world population. In fact, we will implicitly assume that there are nationalities for which the probability of the hair color red is 1.

<sup>4</sup>See Ba et al. (2022) for recent work that instead, consistent with our Smooth DE framework, emphasizes and provides experimental evidence for the role shape of the prior distribution in affecting overreaction.



Figure 1: News and uncertainty in a two-states discrete distribution



*Notes:* The figure displays how, as we vary the actual  $P(\hat{x} = R|Nationality)$ , the following objects change: (a.1) the distorted probability of red hair, (a.2) the distorting weight on the red hair probability, (b.1) the news component, measured using the KL defined in equation (5), (b.2) the uncertainty component, measured using the normalized entropy of the actual distribution in equation (6), (c.1) the overall overreaction, measured by the KL divergence of the distorted probability distribution from the actual one, defined in equation (7), and (c.2) the entropy of the distorted distribution relative to the entropy of the actual distribution. We fix the reference probability of a red hair color at  $P(\hat{x} = R|World)=0.2$ .

tion (3), the distorting weight is then larger in absolute terms, and therefore there is more overreaction to the news. On the other hand, there is an *uncertainty effect*: the more the knowledge of a given Nationality decreases the uncertainty over the hair color, the less room there is for overreaction to effectively manifest itself. This intuitive force mathematically appears in equation (3) through the constant of integration of equation (4). The news and uncertainty effects are jointly determined by the shapes of the distributions getting compared through representativeness. We dissect these effects through a series of plots in Figure 1.

First, Panel (a.1) already shows that the difference between the distorted and underlying probability is *hump-shaped*. This difference is largest for intermediate values between the prior of 0.2 and the lower and upper bounds (0 and 1). By equation (2) the reason for the hump shape is the behavior of the distorting *weight* ( $\hat{x} = R|Nationality, World$ ), which gets plotted in Figure 1 (a.2). Indeed, the weight is non-monotonic in the actual frequency: the weight is increasing from an underlying  $P(\hat{x} = R|Nationality) = 0$  to some intermediate

value between the reference frequency of 0.2 and the upper bound of 1 and then starts decreasing. Formally, this is because the constant of integration in equation (4) becomes larger as the frequency  $P(\hat{x} = R|Nationality)$  approaches 1. Intuitively, as the actual frequency for a given Nationality becomes more certain towards one hair color, the room for distortion becomes smaller as the total probability has to sum to 1.

Second, we dissect the news and uncertainty channels by using information-theoretic measures. In Panel (b.1), we measure the size of the *news* component. This is given by the change in the distribution induced by conditioning on a Nationality as opposed to conditioning on World, as measured by the Kullback-Leibler (KL) divergence of the two distributions:

$$KL(Nationality||World) = \sum_i P(\hat{x} = i|Nationality) \ln \left( \frac{P(\hat{x} = i|Nationality)}{P(\hat{x} = i|World)} \right). \quad (5)$$

The KL divergence is U-shaped, with  $KL = 0$  when knowing the Nationality does not imply any revision in the distribution.

To measure *uncertainty* for the objective distribution of hair colors for a given Nationality, Panel (b.2) in Figure 1 plots the normalized entropy

$$\Omega(P(Nationality)) = -\frac{\sum_i P(\hat{x} = i|Nationality) \ln P(\hat{x} = i|Nationality)}{\ln(2)}, \quad (6)$$

where the denominator ensures that the normalized entropy is between 0 and 1. This entropy measure of uncertainty is particularly suitable to capture uncertainty in this environment of categorical random variables. The entropy measure shows an *inverted* U-shape and peaks when  $P(\hat{x} = R|Nationality) = 0.5$ , the point of maximum uncertainty in this two-state case.

To measure the extent of the overreaction, Panel (c.1) reports the KL divergence between the perceived frequency and the objective frequency

$$KL(P^\theta||P) = \sum_i P^\theta(\hat{x} = i|Nationality, World) \ln \left( \frac{P^\theta(\hat{x} = i|Nationality, World)}{P(\hat{x} = i|Nationality)} \right). \quad (7)$$

We can now see how the degree of overreaction shows two humps: a smaller one that peaks at an intermediate value between 0 and reference frequency  $P(\hat{x} = R|World) = 0.2$ , and a larger one that peaks at an intermediate value between that reference of 0.2 and the upper bound of 1. The two humps are the result of the *interaction between news and uncertainty effects*, which affect overreaction, but display opposing patterns (U- and inverted U-shape). The particular sizes of the two humps are different because the trough of the news component and the peak of the uncertainty effect do not coincide (see panels (b.1) and (b.2)).

3. **Over/under confidence.** Overreaction to information also affects perceived uncertainty compared to objective uncertainty. Panel (c.2) reports the entropy  $\Omega(P^\theta(Nationality))$  of the distorted distribution normalized with respect to the entropy  $\Omega(P(Nationality))$  of the objective distribution. A relative entropy smaller than 0 implies overconfidence: the agent is too certain about the hair color compared to the objective distribution.

The interaction between the news effect and uncertainty effect leads to an interesting pattern. First, there is no over- or underconfidence if there is no news (i.e. the distributions conditional on Nationality or World coincide) or the news completely removes uncertainty ( $P(\hat{x} = R|Nationality) = \{0, 1\}$ ). Second, when the frequency of red hair is smaller for a given Nationality than for the World, news and uncertainty effects work in the same direction, and only over-confidence is possible. Third, when instead the relative frequency is larger, the two effects can work in opposite directions. On the one hand, uncertainty keeps increasing until the frequency is .5, at which point uncertainty starts decreasing again. As a result, for small increases in the relative frequency of red hair, over-reaction to that relative frequency can lead to underconfidence. Eventually, the news effects starts dominating, leading to overconfidence. Finally, the strength of overconfidence declines as the news starts to fully remove uncertainty. The degree of overconfidence is more severe for an actual frequency on the right tail ( $P(\hat{x} = R|Nationality) > 0.8$ ) than on the left tail ( $P(\hat{x} = R|Nationality) < 0.2$ ). This is because the news effect is larger for a frequency on the right of a small probability event such as the one considered in this example.

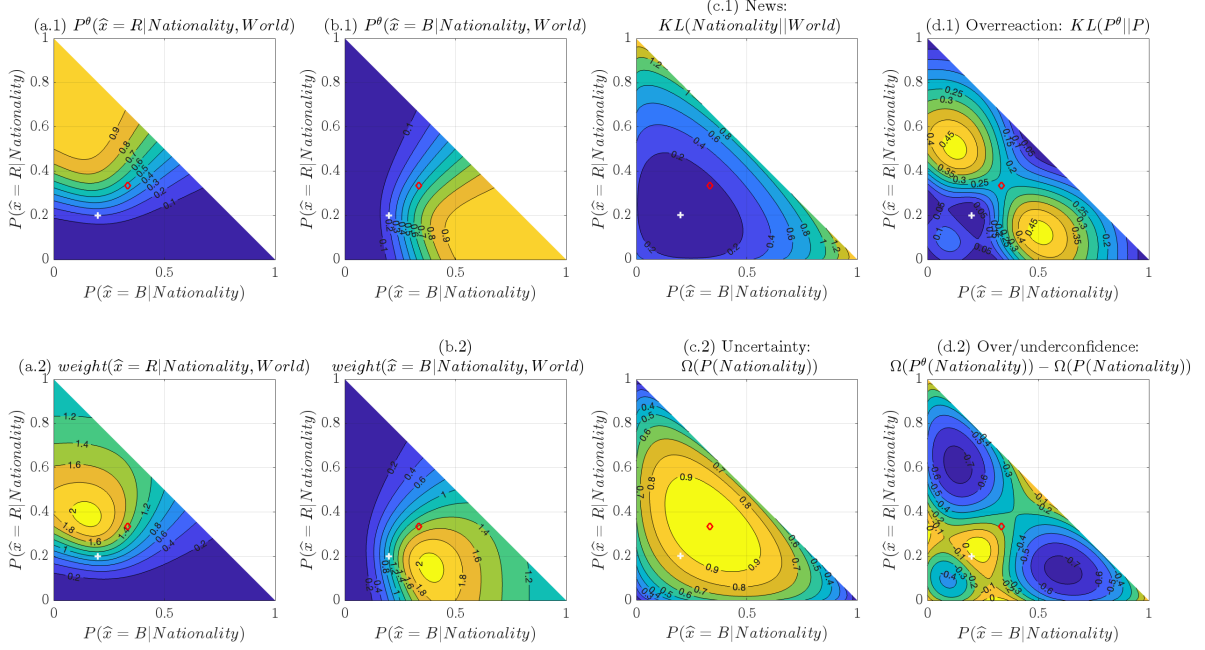
## 2.2 Three-state distribution

Consider now an extension of the event space to three hair colors - “red,” “blond,” and “dark,” denoted by  $R$ ,  $B$ , and  $D$ , respectively. We consider a symmetric reference frequency for  $R$  and  $B$  so that conditional on World, their frequencies are equal to 0.2, while for  $D$  it is equal to 0.6. This three-state example is instructive because the actual frequencies of  $R$  and  $B$  for a given Nationality jointly determine the news and uncertainty component, thus underscoring the importance of the *shape* of the joint probability *distribution* in affecting the degree of overreaction.

In Figure 2, we use contour plots to examine how news and uncertainty affect overreaction as we vary  $P(\hat{x} = R|Nationality)$  and  $P(\hat{x} = B|Nationality)$  when  $\theta = 2$ . To ease interpretation, we mark the coordinates corresponding to the reference frequencies with white pluses, and the coordinates representing the equal probabilities of 1/3 for all three outcomes with red diamonds. We can recover the three properties discussed for the two-state example:

1. **Overreaction.** Panels (a.1) and (a.2) report the distorted probability and the weight

Figure 2: News and uncertainty in a three-states discrete distribution



*Notes:* The figure displays how, the probability of red and blond hair colors for a given Nationality varies, the following objects change: (a.1) the distorted probability of red hair, (a.2) the distorting weight on the red hair probability, (b.1) the distorted probability of blond hair, (b.2) the distorting weight on the blond hair probability, (c.1) the news component, measured using the KL defined in equation (5), (c.2) the uncertainty component, measured using the normalized entropy of the actual distribution in equation (6), (d.1) the overall overreaction, measured using the KL divergence of the distorted probability distribution from the objective one, defined in equation (7), and (d.2) the entropy of the distorted distribution relative to the entropy of the objective distribution. We mark the coordinates for the reference probabilities with white pluses, and those representing equal probabilities for all three outcomes with red diamonds.

associated with the red hair color. As in the two-states example, the distorted probabilities overreact to the relative frequency of red hair for the given Nationality compared to the World. The distorting weight of the red probability peaks when  $P(\hat{x} = R|Nationality)$  takes an intermediate value between 0.2 and 1 and  $P(\hat{x} = B|Nationality)$  takes an intermediate value between 0 and 0.2. Similarly, Panel (b.1) and (b.2) report the distorting probability and the weight associated with a blond hair color.

**2. News and Uncertainty.** The three state example is particularly useful here to see how the shape of the distributions matter. Panel (c.1) displays the news component, measured again as the  $KL(Nationality||World)$  of equation (5). The news component increases as the two distributions differ and peaks when either of the hair color outcomes reaches certainty ( $P(\hat{x} = R|Nationality) = 1$  or  $P(\hat{x} = B|Nationality) = 1$ ). The uncertainty component,  $\Omega(Nationality)$ , reported in Panel (c.2) peaks when the distribution for a given

Nationality assigns equal probabilities for all three outcomes.

Panel (d.1) reports the  $KL(P^\theta||P)$  divergence of equation (7). The overreaction displays twin peaks resembling the double humps in the two-states example. However, in the current three-state example how the actual frequencies are split matters for the overreaction. Indeed, the overreaction is mild as we increase both the actual probabilities of red and blond hair simultaneously in equal proportions. This is because both hair colors are becoming more representative for the given Nationality compared to the World.

**3. Over/under confidence.** Panel (d.2) reports the entropy  $\Omega(P^\theta(Nationality))$  with respect to the objective entropy  $\Omega(P(Nationality))$ . The former is smaller in most regions, indicating overconfidence, except for the neighborhood of the reference frequency and the coordinate representing equal probabilities for all three outcomes. Overconfidence is most severe around the three corners of the triangle, when the actual frequency puts most probability weights on one hair color. Intuitively, as one specific hair color becomes more representative, the agent overestimates the probability of that hair color and becomes too certain. As before, overconfidence eventually disappears as uncertainty is fully removed.

### 3 Smooth Diagnostic Expectations

In this section, we show that the key principles uncovered for categorical distributions naturally find their counterparts under Smooth DE, which allows for continuous distributions and accumulation of information. In particular, in order to model the representativeness heuristic into the time series domain, we mirror the logic of equation (1), and interpret groups as different information sets that become available over time.

#### 3.1 Smooth DE density: representativeness and information sets

We introduce the definition of representativeness and information sets with some generality. Consider the filtered probability space  $(\Omega, \mathcal{F}, (\mathcal{F}_t)_{t \geq 0}, P)$  where  $(\mathcal{F}_t)_{t \geq 0}$  is an increasing family of sub- $\sigma$ -algebras of  $\mathcal{F}$ , with  $\mathcal{F}_t \subset \mathcal{F}_{t+1}$ . Here the filtration  $(\mathcal{F}_t)_{t \geq 0}$  represents the evolution of information over time. A stochastic process  $(X_t)_{(t \geq 0)}$  on  $(\Omega, \mathcal{F}, P)$  is adapted to the filtration  $(\mathcal{F}_t)_{t \geq 0}$  if, for each  $t \geq 0$ ,  $X_t$  is  $\mathcal{F}_t$ -measurable. Let the conditional density function of  $X_{t+h}$ , for some horizon  $h \geq 1$ , given the filtration  $\mathcal{F}_t$ , be denoted by  $f(x_{t+h}|\mathcal{F}_t)$ . This function describes the probability density of  $X_{t+h}$ , given all the information available up to time  $t$ .

In our approach, the counterpart of equation (1) is obtained by defining the reference group as a past available information set. As information flows and is accumulated, representativeness is then defined as follows:

**Definition 1 (*Representativeness and information sets*)** Given the current information set  $\mathcal{F}_t$  and a reference information set  $\mathcal{F}_{t-J}$ , formed  $J \geq 1$  periods ago, the representativeness of a random event  $\hat{x}_{t+h}$  for some future horizon  $h \geq 1$  is defined as

$$rep(\hat{x}_{t+h}|\mathcal{F}_t, \mathcal{F}_{t-J}) \equiv \frac{f(\hat{x}_{t+h}|\mathcal{F}_t)}{f(\hat{x}_{t+h}|\mathcal{F}_{t-J})} \quad (8)$$

Mirroring the language of Tversky and Kahneman (1975) in Section 2, in the time-series domain an event is representative for the current information set if the relative frequency of this event is higher conditional on the current information set than conditional on some past reference information set.<sup>5</sup>

Based on this definition of the representativeness of an event, we then follow the same construction of the distorted belief as introduced early in equation (2) in Section 2. In particular, we build the following distorted conditional density, which we refer to as *Smooth Diagnostic Expectations*, or in a more abbreviated form as Smooth DE.

**Definition 2 (*Smooth Diagnostic Expectations*)**. In the time series domain, the conditional density  $f^\theta(\hat{x}_{t+h}|\mathcal{F}_t, \mathcal{F}_{t-J})$ , distorted by representativeness as defined in Definition 1, is constructed as follows

$$f^\theta(\hat{x}_{t+h}|\mathcal{F}_t, \mathcal{F}_{t-J}) = f(\hat{x}_{t+h}|\mathcal{F}_t) [rep(\hat{x}_{t+h}|\mathcal{F}_t, \mathcal{F}_{t-J})]^\theta / Z \quad (9)$$

where  $Z$  is a constant of integration and the parameter  $\theta \geq 0$  measures the distortion severity.

Our formalization of Smooth DE strongly connects to that of DE introduced in BGS to incorporate representativeness in time series. As we detail further below, the only, but consequential difference is in the construction of the reference group in the definition of representativeness. Given such a definition, the functional form for the distorted density in equation (9) is identical to DE.

### 3.2 Smooth DE with Normal densities

In the rest of this paper we follow BGS and focus on normal densities. As we show below, this leads to significant gains in tractability and in the range of possible applications. This is because when the true conditional density is Normal, expression (9) delivers a distorted distribution that is also Normal. However, while this a natural point of departure, Smooth DE can easily accommodate alternative distributions, as we illustrated in Section 2.

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<sup>5</sup>The approach is easily extended when the available information is incomplete or noisy - see Section G.

With Normal densities, two moments, the conditional mean  $\mu_{t+h|s}$  and conditional variance  $\sigma_{t+h|s}^2$ , summarize the whole conditioning information:

$$f(\hat{x}_{t+h}|\mathcal{F}_s) = \mathcal{N}(\hat{x}_{t+h}; \mu_{t+h|s}, \sigma_{t+h|s}^2), \quad \text{for } s \leq t$$

It follows that given Definition 1, the representativeness of the event  $\hat{x}_{t+h}$  is evaluated as

$$rep(\hat{x}_{t+h}|\mathcal{F}_t, \mathcal{F}_{t-J}) = \frac{N(\hat{x}_{t+h}; \mu_{t+h|t}, \sigma_{t+h|t}^2)}{N(\hat{x}_{t+h}; \mu_{t+h|t-J}, \sigma_{t+h|t-J}^2)}, \quad (10)$$

capturing its relative frequency under the current information set  $\mathcal{F}_t$ , compared to some past information set  $\mathcal{F}_{t-J}$ , with  $J \geq 1$ .

Under the representativeness characterizing normal densities in equation (10), the Smooth DE density in equation (9) has a closed-form solution given by Proposition 1 below.

**Proposition 1** *Denote the ratio of variances for the current and reference groups as*

$$R_{t+h|t,t-J} \equiv \sigma_{t+h|t}^2 / \sigma_{t+h|t-J}^2 \quad (11)$$

*If  $R_{t+h|t,t-J} < (1 + \theta) / \theta$ , the Smooth DE density  $f^\theta(\hat{x}_{t+h}|\mathcal{F}_t, \mathcal{F}_{t-J})$  in equation (9) is Normal with conditional mean*

$$\mathbb{E}_t^\theta(x_{t+h}) = \mu_{t+h|t} + \theta \frac{R_{t+h|t,t-J}}{1 + \theta(1 - R_{t+h|t,t-J})} (\mu_{t+h|t} - \mu_{t+h|t-J}) \quad (12)$$

*and conditional variance*

$$\mathbb{V}_t^\theta(x_{t+h}) = \frac{\sigma_{t+h|t}^2}{1 + \theta(1 - R_{t+h|t,t-J})} \quad (13)$$

**Proof.** See Appendix. ■

The condition  $R_{t+h|t,t-J} < (1 + \theta) / \theta$  guarantees that the variance of the distorted Normal distribution is finite and positive. As  $R_{t+h|t,t-J}$  approaches this limit, the variance of the Smooth DE distribution approaches infinity and the corresponding Normal distribution approaches a degenerate, flat distribution. Thus, the condition requires that the current uncertainty of a future event ( $\sigma_{t+h|t}^2$ ) is not too high compared to the past uncertainty about the same event ( $\sigma_{t+h|t-J}^2$ ), which typically holds in stationary environments with homoskedastic innovations in which it is easier to predict events closer than farther into the future. However, the condition allows for an increase in uncertainty, for example as a result of heteroskedasticity, as long as the increase is not too large with respect to the DE distortion.<sup>6</sup>

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<sup>6</sup>In Appendix B we discuss an approach that deals with this threshold condition by implementing an

### 3.3 Three key properties

Smooth DE is characterized by three important properties. To understand them, it is helpful to define the effective overreaction of the conditional mean to news in equation (12) as

$$\tilde{\theta}_{t,t-J} \equiv \theta \frac{R_{t+h|t,t-J}}{1 + \theta (1 - R_{t+h|t,t-J})}. \quad (14)$$

**Corollary 1** *Assume the presence of residual uncertainty with respect to a future event:  $\sigma_{t+h|t}^2 > 0$ . Compared to the RE forecast ( $\theta = 0$ ), the conditional forecast under Smooth DE ( $\theta > 0$ ), characterized in Proposition 1, exhibits*

1. *overreaction of the conditional mean to new information, since  $\tilde{\theta}_{t,t-J} > 0$ .*
2. *an effective overreaction of the conditional mean to new information that is monotonically increasing in the ratio  $R_{t+h|t,t-J}$  between current and past uncertainty*

$$\frac{\partial \tilde{\theta}_{t,t-J}}{\partial R_{t+h|t,t-J}} > 0 \quad (15)$$

3. *overconfidence when  $R_{t+h|t,t-J} < 1$ , since then by equation (13)*

$$\mathbb{V}_t^\theta(x_{t+h}) < \sigma_{t+h|t}^2 \quad (16)$$

*or underconfidence when  $R_{t+h|t,t-J} > 1$ , since then by equation (13)*

$$\mathbb{V}_t^\theta(x_{t+h}) > \sigma_{t+h|t}^2. \quad (17)$$

On the one hand, these properties mirror the qualitative ones for the static, discrete state example introduced and discussed in Section 2.1: ‘overreaction’, ‘news and uncertainty’, and ‘over/under confidence’, respectively. The closed-form solution of Normal densities make these properties particularly transparent. This connection is useful, indicating that Smooth DE maintains similar insights when extending the concept of representativeness and overreaction to new information to dynamic models. Additionally, the tractability of the Normal distribution in the time series domain will allow us to connect these three properties to stylized survey facts in Section 3.5.

The first property in Corollary 1, overreaction of the conditional mean, is an immediate manifestation of the amplification of the relative frequency of an event that becomes more

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upper bound on the Smooth DE overreaction in the conditional mean. The approach guarantees that both the mean and variance distortions remain finite and non-decreasing as the ratio  $R_{t+h|t,t-J}$  goes to infinity.



likely. This property is shared with the standard DE approach, as we detail further below. The other two properties are novel and reflect the tight connection between uncertainty and the degree of overreaction, in line with the analysis presented in Section 2.

Like in the static, discrete case, the *shapes* of the current and reference densities matter for the effective degree of overreaction. In the Normal case, the shape is summarized only by the conditional uncertainty. Indeed, Smooth DE formally captures how the severity of the mean distortion *increases* as the ratio  $R_{t+h|t,t-J}$  of today's uncertainty to past uncertainty increases. Smooth DE thus micro-founds in a time-series domain an inverse smooth link between overreaction to news and the precision of the news compared to the reference distribution. This is captured by the ratio  $R_{t+h|t,t-J}$ : The more the new information reduces uncertainty  $\sigma_{t+h|t}^2$  compared to  $\sigma_{t+h|t-J}^2$ , the lower is the role of memory in distorting probability judgements, and thus the lower is the effective overreaction to news. Conversely, everything else equal, the larger today's uncertainty, the larger the Smooth DE distortion.

Similar to the basic intuition of the static, discrete case, Smooth DE also has important implications for the level of subjective *confidence* that agents express with respect to their expectations. As summarized in Corollary 1, if agents experience a reduction of uncertainty with respect to the reference distribution, so that  $R_{t+h|t,t-J} < 1$ , Smooth DE implies *overconfidence*, i.e. agents overstate the precision of their expectations. Under this scenario, independently of the direction and size of the mean distortion, agents are overconfident about the precision of their expectations. If agents do not experience a change in uncertainty, and  $R_{t+h|t,t-J} = 1$ , we do not observe a change in confidence with respect to  $\sigma_{t+h|t}^2$ . Finally, if agents experience an increase in uncertainty, so that  $R_{t+h|t,t-J} > 1$ , they will be less confident than under the true density.

### 3.4 Standard DE

The standard approach to apply representativeness in the time-series domain follows the BGS formulation, in which the representativeness of  $\hat{x}_{t+h}$  is given by the relative frequency

$$rep^{BGS}(\hat{x}_{t+h}|\mathcal{F}_t, \mathcal{F}_{t-J}) \equiv \frac{N(\hat{x}_{t+h}; \mu_{t+h|t}, \sigma_{t+h|t}^2)}{N(\hat{x}_{t+h}; \mu_{t+h|t-J}, \sigma_{t+h|t}^2)}, \quad (18)$$

In equation (18), the reference density uses the mean conditional on the information  $\mathcal{F}_{t-J}$  available  $J$  periods ago,  $\mu_{t+h|t-J}$ , but the uncertainty conditional on the current information set  $\mathcal{F}_t$ ,  $\sigma_{t+h|t}$ . The reference density can thus be understood as a mixture of information sets, meant to keep the conditional uncertainty the same for the current and reference density.

Instead, under Smooth DE, the reference density captures entirely and solely the role of new information, as the difference between information sets  $\mathcal{F}_t$  and  $\mathcal{F}_{t-J}$ . Under Normality,

comparing the definition of representativeness in equations (10) and (18), this difference formally manifests itself in the *variance* of the reference distribution.

This BGS assumption delivers the following closed form standard DE density:

**Proposition 2** (*BGS implementation for DE*). *Consider the BGS definition of representativeness in equation (18). When  $\sigma_{t+h|t}^2 > 0$ , the resulting DE density  $f^\theta(\hat{x}_{t+h}|\mathcal{F}_t, \mathcal{F}_{t-J})$  defined by equation (9) has a Normal distribution with mean:*

$$\mathbb{E}_t^\theta(x_{t+h}) = \mu_{t+h|t} + \theta [\mu_{t+h|t} - \mu_{t+h|t-J}] . \quad (19)$$

and variance  $\mathbb{V}_t^\theta(x_{t+h}) = \sigma_{t+h|t}^2$ . When  $\sigma_{t+h|t}^2 = 0$ , the DE conditional mean  $\mathbb{E}_t^\theta(x_{t+h})$  collapses to  $\mu_{t+h|t}$ .

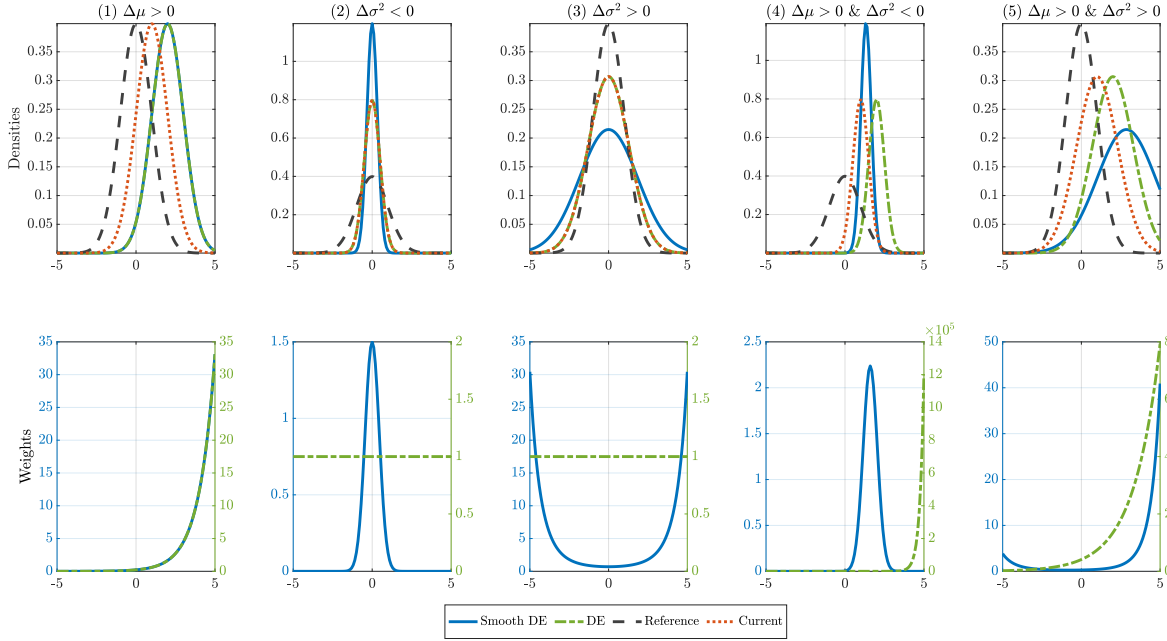
**Proof.** See Bordalo et al. (2018). ■

Smooth DE and the standard BGS formulation of DE coincide in two cases. First, in the limit of no conditional uncertainty. In particular, in both approaches, with  $\theta > 0$ , there is a distortion if and only if the conditional variance  $\sigma_{t+h|t}^2 > 0$ . Intuitively, when  $\sigma_{t+h|t}^2 = 0$ , the conditional likelihood of observing any other scenario for  $x_{t+h}$  than the one the agent is now fully informed on has become equal to zero. As noted by Gennaioli and Shleifer (2010), the lack of such conditional (or “residual”) uncertainty leaves no room for memory to distort conditional forecasts. According to Proposition 1, Smooth DE formally nests that limiting possibility, which would amount to  $R_{t+h|t,t-J} = 0$  and thus effectively no distortion even if  $\theta > 0$ . In the BGS formulation that limit is instead imposed through a discontinuity at  $\sigma_{t+h|t}^2 = 0$ : in the language developed in Bordalo et al. (2018), to compute  $\mathbb{E}_t^\theta(x_{t+h})$  the realization  $x_{t+h}$  constitutes its infinitely representative state (see appendix in Bordalo et al. (2018) on Corollary 1), and the result is  $\mathbb{E}_t^\theta(x_{t+h}) = \mu_{t+h|t}$ . Under Smooth DE the effective overreaction  $\tilde{\theta}_{t,t-J}$  in equation (14) *smoothly* goes to zero as current uncertainty goes to zero.

Second, and more importantly, away from the zero conditional uncertainty case, in the original BGS formulation the ratio  $R_{t+h|t,t-J}$  is always 1 by assumption. Thus, DE coincides with Smooth DE if and only if the stochastic process is characterized by information sets  $\mathcal{F}_t$  and  $\mathcal{F}_{t-J}$  that happen to deliver  $\sigma_{t+h|t}^2 = \sigma_{t+h|t-J}^2, \forall t$  and for any given  $J$ . Indeed, if  $R_{t+h|t,t-J} = 1$  in Proposition 1 the effective overreaction  $\tilde{\theta}_{t,t-J} = \theta$ , and formulas (12) and (13) collapse to their respective counterparts in Proposition 2.

In Figure 3 we use a series of illustrative examples to show the different effects at work in Corollary 1. In the first row, we report the reference, current, DE, and Smooth DE distributions. In the second row, we report the weights that capture the belief distortion

Figure 3: Smooth Diagnostic Expectations and standard Diagnostic Expectations densities



*Notes:* The figure is obtained using the following parameter values for the mean and variances of the current and reference distributions:  $\mu_{t+h|t-J} = [0, 0, 0, 0, 0]$ ,  $\mu_{t+h|t} = [1, 0, 0, 1, 1]$ ,  $\sigma_{t+h|t-J}^2 = [1, 1, 1, 1, 1]$ , and  $\sigma_{t+h|t}^2 = [1, .5, 1.3, .5, 1.3]$ .

under DE and under Smooth DE. These are computed as:

$$weight(\hat{x}_{t+h}) \equiv \left( \frac{N(\hat{x}_{t+h}; \mu_{t+h|t}, \sigma_{t+h|t}^2)}{N(\hat{x}_{t+h}; \mu_{t+h|t-J}, \sigma_{t+h|t-J}^2)} \right)^\theta \frac{1}{Z},$$

for the standard DE and

$$weight(\hat{x}_{t+h}) = \left( \frac{N(\hat{x}_{t+h}; \mu_{t+h|t}, \sigma_{t+h|t}^2)}{N(\hat{x}_{t+h}; \mu_{t+h|t-J}, \sigma_{t+h|t-J}^2)} \right)^\theta \frac{1}{Z},$$

for the Smooth DE, where the constant of integration accounts for the respective formulation.

We organize the examples to follow the three key properties presented in Section 2 and formally characterized for the Normal distribution in Corollary 1.<sup>7</sup>

**Overreaction of the conditional mean to new information.** Consider first a case in which the reference and current distributions only differ in terms of the mean:  $\mu_{t+h|t} > \mu_{t+h|t-J}$ . The new information does not induce any change in uncertainty and  $R_{t+h|t,t-J} = 1$ .

<sup>7</sup>Appendix D uses these examples to further and more generally discuss how the news and uncertainty effects introduced in Section 2 determine the effective overreaction of the Smooth DE density.

Smooth DE and DE lead to the same normal distribution, in which only the conditional mean is distorted. Both the SDE and DE means are shifted to the right with respect to the current distribution by  $\theta(\mu_{t+h|t} - \mu_{t+h|t-J})$ . The lower panel in the first column shows that the weights increase moving from left to right: The weights shift probability mass to the right of the current density, lowering the probability assigned to events that became less likely, and inflating the probability of events that became more likely. The weights keep increasing as elements in the right tail of the current density became much more likely to occur *in relative terms*. However, the true probability of these events goes to zero faster than the weights increase, preserving the normality of the SDE and DE distributions.

**Over/underconfidence.** In the second and third columns, the reference and current distributions *only differ in terms of variance*, while  $\mu_{t+h|t} = \mu_{t+h|t-J}$ . In the second column the current true distribution features a *lower* variance, i.e.  $\sigma_{t+h|t}^2 < \sigma_{t+h|t-J}^2$  and thus  $R_{t+h|t,t-J} < 1$ . This case is typical for standard stochastic processes when new information leads to a reduction of uncertainty and more precise forecasts. Under the standard BGS implementation of DE, the fact that events close to the mean, and the mean itself, became more likely does not have any effect. Instead, under Smooth DE, the agent revises her beliefs in light of the new information. She inflates the probability of the mean and the other events that became more *representative*, while further downplaying the probability of events that became less likely. The result is an even narrower distribution than the current true distribution. Under Smooth DE, the new information leads to *overreaction* in terms of the decline in uncertainty and, as a result, to a novel implication: overconfidence.

In the third case the current distribution has a *larger* variance than the reference distribution, i.e.  $\sigma_{t+h|t}^2 > \sigma_{t+h|t-J}^2$ , and thus  $R_{t+h|t,t-J} > 1$ . This situation could arise, for example, in response to a positive uncertainty shock. Now tail events become more representative under the revised density and receive a magnified weight under Smooth DE. The probability mass is moved from the center to the tails, but preserving normality.<sup>8</sup> Under DE, the weights are once again uniformly equal to 1, and the DE density coincides with the true density.

**Changes in uncertainty affect the overreaction of the conditional mean.** The fourth and fifth columns combine a revision in mean with a revision in variance. The key observation here is illustrated by Corollary 1: under Smooth DE, a change in uncertainty affects the degree to which the distorted revision responds to the true revision. Since changes in information sets typically involve actual changes in both conditional moments, this is a

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<sup>8</sup>This example also allows us to illustrate the role of the upper bound on  $R_{t+h|t,t-J}$  in Proposition 1: As this ratio increases, more and more probability mass is moved to the tails, flattening the normal distribution. As  $R_{t+h|t,t-J} \rightarrow (1+\theta)/\theta$ , the variance of the Smooth DE density goes to infinity, as an increasing probability mass is moved to the tails.

particularly novel and important aspect of Smooth DE.

In particular, the fourth case combines the first two, with an *increase in the conditional mean and a reduction of conditional uncertainty*. As in the first case, under DE we observe a shift of the probability mass to the right. Accordingly, the DE density moves to the right, but with no change in shape with respect to the true density. Under Smooth DE, instead, the agent recognizes that, despite the increase in the mean, the new information made tail events to the right less representative. Thus, for a given  $\theta$ , the Smooth DE density still shifts to the right, but by a smaller amount, and becomes visibly narrower, as the weights take into account the change in uncertainty.<sup>9</sup>

Finally, new information can also bring a shift in the mean, but now with *more* uncertainty. The last column considers this case, where the shift in the mean is positive like in the fourth column. The agent's overreaction in terms of revisions to the conditional mean is now *stronger* than under standard DE because tail events have become more likely under the current distribution. Thus, the weights determine an even more significant shift of probability mass to the right (the scale for the SDE weights is on the left). In terms of distorted conditional uncertainty, in this case, we observe underconfidence. This is again in itself a form of *overreaction*, as the agent magnifies the increase in uncertainty as this appears large compared to the reference uncertainty.

### 3.5 AR(1) process

The Smooth DE density can be easily applied for a standard AR(1) process  $x_{t+1} = \rho x_t + \varepsilon_{t+1}$ , with  $\mathcal{N}(0, \sigma^2)$ , where  $\rho < 1$  and  $\sigma^2 > 0$ . By Proposition 1, for an horizon  $h \geq 1$  and a  $J$ -lagged reference distribution, the conditional mean for the Smooth DE density  $f^\theta(\hat{x}_{t+h})$  is

$$\mathbb{E}_t^\theta(x_{t+h}) = \rho^h x_t + \tilde{\theta}_{t,t-J} (\rho^h x_t - \rho^{h+J} x_{t-J}), \quad (20)$$

where, according to equation (14), the effective severity  $\tilde{\theta}_{t,t-J}$  of the DE distortion depends on the ratio  $R_{t+h|t,t-J}$  of conditional variances. Given the AR(1) process, this ratio becomes

$$R_{t+h|t,t-J} = \frac{\mathbb{V}_t[x_{t+h}]}{\mathbb{V}_{t-J}[x_{t+h}]} = \frac{1 - \rho^{2h}}{1 - \rho^{2(h+J)}} \quad (21)$$

The AR(1) example illustrates well some of the general principles behind Smooth DE, summarized by Corollary 1. First, like standard DE, by equation (20), as long as  $\theta >$

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<sup>9</sup>As the current conditional uncertainty becomes continuously smaller and converges to zero, the shift in the distorted conditional mean also smoothly converges to zero. In contrast, under standard DE, there would be a discrete jump in the extreme case of  $\sigma_{t+h|t=0}^2$ .

0, Smooth DE exhibits effective overreaction of the conditional mean to news. However, Corollary 1 further indicates how Smooth DE brings novel implications, which in the context of this AR(1) example can also be connected to some stylized survey evidence, as follows.

**Stronger overreaction for longer forecast horizons.** One set of over-identifying restrictions on our theory of overreaction relates to the model’s implications for short- versus long-horizon forecasts. A strand of literature using survey data argues that overreaction increases with the forecast horizon. For example, Bordalo et al. (2019) and Bordalo et al. (2023) point to such stronger overreaction for equity analysts’ forecasts of long-term earning growth and emphasize the potential for this type of overreaction to account for stock market volatility. Using professional forecasters’ forecasts of interest rates, other contributions, including Bordalo et al. (2020), d’Arienzo (2020), find evidence of significant overreaction for expectations of long-term interest rates, but not for expectations of short-term interest rates. Augenblick et al. (2021) use field data from betting and financial markets to argue that compared to the Bayesian forecast there is relatively stronger overreaction to signals with a longer time-to-resolution, conceptually similar to longer forecast horizons.

Smooth DE is consistent with such evidence as it predicts that overreaction increases with the horizon of the forecast. The basic intuition is that the same piece of information is less informative about horizons further in the future, leading to a smaller reduction in uncertainty and a stronger overreaction. In the AR(1) case, this logic can be established as:

**Corollary 2** *The ratio  $R_{t+h|t,t-J}$  in equation (21) increases in the forecast horizon  $h$ . Thus, the effective overreaction  $\tilde{\theta}_{t,t-J}^\theta$  of  $\mathbb{E}_t^\theta(x_{t+h})$  in equation (20) is stronger for larger  $h$ .*

For a given lag  $J$  in the reference distribution, as the forecast horizon  $h$  increases, the effective horizon of the current RE forecast ( $h$ ), and the effective horizon of the reference RE forecast ( $h + J$ ) become increasingly similar. As a result, the levels of uncertainty associated with the two forecasts also become increasingly similar because, in relative terms, the current information set is less and less informative for the variable that the agent is trying to predict. Given that under Smooth DE overreaction is increasing in the level of relative uncertainty, as  $h$  increases, so does the amount of overreaction to a given revision of the RE forecast.

**Overreaction and overconfidence.** A recent literature studying the properties of survey responses, including Barrero (2022), Born et al. (2022), and the reviews in Altig et al. (2020) and Born et al. (2022), documents that firms not only *overreact* to news, but that they are also typically *overconfident* in their subjective forecasts. Smooth DE is also consistent with this second stylized fact. By Corollary 1, overconfidence is a ‘typical’ property characterizing Smooth DE, because the condition for overconfidence is that new information reduces uncertainty. This condition is ubiquitous as it holds in stationary, homoskedastic

environments, where events closer into the future are naturally easier to predict than events far into the future.<sup>10</sup> The simple AR(1) example presented above illustrates this property well, as in equation (21) the ratio  $R_{t+h|t,t-J} < 1$ , for any  $h \geq 1$  and  $J \geq 1$ . By Corollary 1, the Smooth DE density is characterized by subjective overconfidence, since  $\mathbb{V}_t^\theta(x_{t+h}) < \mathbb{V}_t(x_{t+h})$ .

## 4 New survey evidence: Overreaction and Uncertainty

Using SPF data, we uncover a novel stylized fact that strongly supports the key implication of Smooth DE: forecasts overreact more when uncertainty is high (Corollary 1).

**Data.** We study how survey forecasters react to new information depending on the level of uncertainty using the quarterly individual-level SPF forecast data (1968:Q4–2023:Q2). The surveys are collected in the second month of each quarter and report forecasts of the current and the next four quarter’s outcome of the variables in question. We study forecasts of 15 macro variables, including GDP, consumption, and investment, CPI, unemployment rate, and short- and long-term interest rates. Appendix E reports details of the variables construction, while here we summarize the key steps.

We follow Bordalo et al. (2020) to construct the dataset and focus on a one-year-ahead horizon. Since most SPF forecasts are in levels, for variables such as GDP and prices, we convert them into implied growth rates by taking growth rates from quarter  $t - 1$  levels to quarter  $t + 3$  forecasts. For variables such as the unemployment rate and interest rates, we study the  $t + 3$ -quarter-ahead levels. The data cleaning procedure, described in Appendix E, results in 23 independent forecaster observations on average per quarter for each series. Next, consider the data on actual outcomes. Macroeconomic variables are often revised after the initial release. To capture the forecasters’ information set as closely as possible, we use the initial releases from the Philadelphia Fed’s Real-Time Data Set for Macroeconomists. Since financial data are not revised, for the interest rates we use historical data from the St Louis Fed’s FRED.

**Empirical strategy.** We follow Bordalo et al. (2020), which in turn build on Coibion and Gorodnichenko (2015), and study the correlation between forecast revisions and the subsequent forecast errors. Our innovation is to examine how this correlation depends on the level of uncertainty.

We denote the  $h$ -quarters-ahead forecasts at time  $t$  of a variable  $x$  by a forecaster  $i$  as  $x_{i,t+h|t}$ . The consensus forecast  $x_{t+h|t}$  is given by the mean forecast across forecasters:  $x_{t+h|t} = \sum_{i=1}^I x_{i,t+h|t}$ , where  $I$  is the total number of forecasters. First, consider the original Coibion and Gorodnichenko (2015) regression of consensus forecast errors,  $x_{t+h} - x_{t+h|t}$ , on

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<sup>10</sup>At the same time, the condition might not hold if new information entails a sufficiently large and unexpected increase in uncertainty, as indicated by some of our examples in Figure 3.

consensus forecast revisions  $x_{t+h|t} - x_{t+h|t-1}$ :

$$x_{t+h} - x_{t+h|t} = \alpha + \beta_C (x_{t+h|t} - x_{t+h|t-1}) + \epsilon_{t,t+h}. \quad (22)$$

Under full-information-rational-expectations (FIRE), forecast errors are unpredictable so  $\beta_C = 0$ .  $\beta_C < 0$  indicates that forecast errors are negatively predictable from forecast revisions. This means that when a forecast revision is positive, the forecast error is on average negative and hence the forecast is too optimistic. Thus we have overreaction of consensus forecasts relative to FIRE. Conversely,  $\beta_C > 0$  means the consensus forecast is on average too pessimistic when the revision is positive, indicating underreaction of consensus forecasts. The rejection of  $\beta_C = 0$  does not necessarily imply a rejection of RE. Indeed, Coibion and Gorodnichenko (2015) show that in a noisy-information rational-expectations model where agents receive private noisy signals and update forecasts in a rational Bayesian manner,  $\beta_C > 0$  can be obtained as a result of the aggregation across individuals.

Bordalo et al. (2020) extend (22) to examine the predictability of forecast errors at the individual level. They pool observations across all forecasters and estimate

$$x_{t+h} - x_{i,t+h|t} = \alpha_i + \beta_I (x_{i,t+h|t} - x_{i,t+h|t-1}) + \epsilon_{i,t,t+h}. \quad (23)$$

Rationality implies that forecast errors are unpredictable at the individual level, so  $\beta_I = 0$ , even with information frictions. In contrast, if individual forecasts overreact relative to RE, we have  $\beta_I < 0$ , and if individual forecasts underreact, we have  $\beta_I > 0$ . Bordalo et al. (2020) find  $\beta_I < 0$  for many macroeconomic variables, consistent with overreaction.

We allow the forecast error predictability in (23) to be state-dependent in order to examine whether and how the degree of overreaction depends on the level of uncertainty:

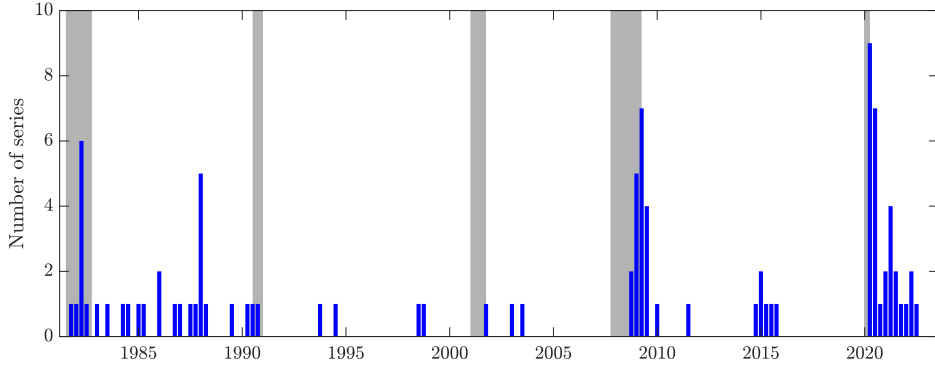
$$x_{t+h} - x_{i,t+h|t} = \alpha_i + \gamma_I (x_{i,t+h|t} - x_{i,t+h|t-1}) + \mathbf{1}\{\sigma_t = \sigma^H\} \times \delta_I (x_{i,t+h|t} - x_{i,t+h|t-1}) + \epsilon_{i,t,t+h}, \quad (24)$$

where  $\mathbf{1}\{\sigma_t = \sigma^H\}$  is a dummy variable that takes the value of one when uncertainty is high ( $\sigma_t = \sigma^H$ ) and zero otherwise. We focus on the state-dependence in the individual-level regressions (23) rather than in the consensus regressions (22) for two reasons. First, we are interested in the degree of departures from RE, whereas the consensus regression does not directly test for rationality. Second, the individual-level regression increases the number of observations in each quarter relative to the consensus regression, thereby enhancing statistical power and making it more suitable for studying the implications of infrequent episodes of sharp increases in uncertainty as documented in Bloom (2009).

The overall predictability of forecast errors is given by  $\gamma_I$  in normal times and by  $(\gamma_I +$



Figure 4: Number of series with cross-sectional dispersion significantly exceeding its mean



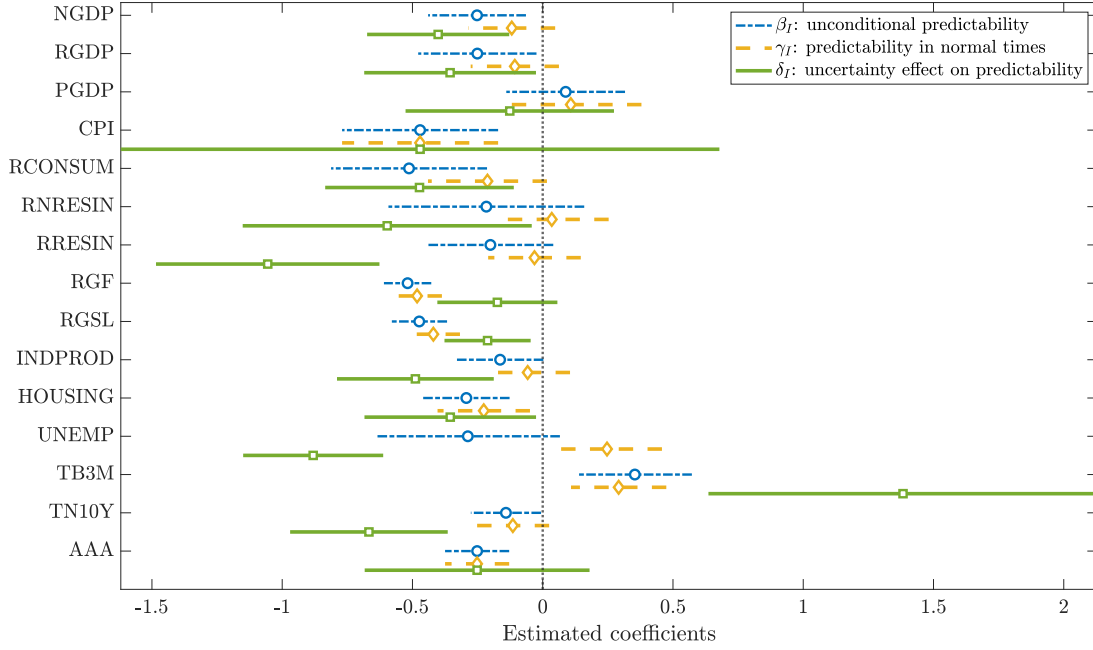
*Notes:* The figure plots, from 1981:Q3 to 2023:Q2, the number of series (out of 14 series) with cross-sectional standard deviations exceeding their time-series means by more than 1.65 standard deviations. The shaded areas are NBER recession dates. We start the graph from 1981:Q3 instead of 1968:Q4 since several SPF forecasts are only available from 1981:Q3. We exclude the Ten-year Treasury rate (TN10Y) from the graph since its SPF forecast is available only from 1992:Q1. As a result, we are left with 14 instead of 15 series.

$\delta_I$ ) when uncertainty is high. If  $\delta_I = 0$ , the forecast error predictability is unchanged between normal and high-uncertainty times. Suppose forecasts overreact relative to RE in normal times,  $\gamma_I < 0$ . Then,  $\delta_I < 0$  implies stronger overreaction in times of high uncertainty. Conversely,  $\delta_I > 0$  corresponds to weaker overreaction when uncertainty is high. An analogous, symmetric relationship holds in the case of underreaction,  $\gamma_I > 0$ .

We measure uncertainty for each variable using the cross-sectional standard deviation of SPF forecasts of that variable. Cross-sectional dispersion of survey forecasts have been used as a measure of uncertainty in several studies, such as Bachmann et al. (2013) and Ilut and Schneider (2014). In addition, as shown below, under Smooth DE there is a tight connection between uncertainty, overreaction, and the cross-sectional dispersion of forecasts, making the cross-sectional standard deviation a natural measure of uncertainty from a theoretical standpoint. We first compute the cross-sectional standard deviation of individual SPF forecasts for each quarter. We then remove low-frequency variation and identify periods of unusually high dispersion. Appendix E provides details on the exact procedure. Figure 4 plots the number of series out of 14 series with cross-sectional standard deviations significantly exceeding their time-series means. There are four periods when the number increased noticeably: the 1981 recession, the immediate aftermath of the Black Monday (1988:Q1), the 2007–2009 Great Recession, and the COVID-19 recession and its aftermath.

**Results.** Figure 5 plots the estimation results for the individual-level regressions (23) and (24), and Table 1 reports the point estimates and standard errors for (22), (23), and (24). Standard errors are Newey and West (1994) with automatic lag selection, and for

Figure 5: Forecast error on forecast revision regression results



*Notes:* The figure reports the estimates from the individual-level forecast error on forecast revision regressions. The blue circles represent the coefficient  $\beta_I$  in the regression (23) and the yellow diamonds and green lines represent the coefficients  $\gamma_I$  and  $\delta_I$  in the regression with uncertainty dummy (24). The bars represent 90% confidence intervals where standard errors are Newey and West (1994) with automatic lag selection and clustered by forecaster and time.

individual-level regressions (23) and (24), clustered by forecaster and time. We control for individual forecaster fixed effects in (23) and (24). The blue circles in Figure 5 and the second column in Table 1 report the forecast error predictability from the individual-level regression (23) without state-dependence. The point estimates for the unconditional predictability  $\beta_I$  are negative for 13 out of 15 series, with 8 of them significant at the 5 percent level. The results indicate that survey expectations exhibit individual-level overreaction, consistent with Bordalo et al. (2020)'s finding using earlier samples. The first column of Table 1 reports the estimates from the consensus Coibion and Gorodnichenko (2015) regression. The point estimates of  $\beta_C$  are positive for 11 out of 15 series, but are significantly positive at the 5 percent level for only 2 of them. The results are in contrast with Bordalo et al. (2020), who find statistically significant consensus-level forecast error predictability for many series. We find that restricting the sample to pre-COVID-19 data brings our results closer to Bordalo et al. (2020).

The yellow diamonds and green squares in Figure 5 and the third and fourth columns

in Table 1 report the estimates from the uncertainty dummy regression (24). The estimates strongly indicate state-dependent overreaction in survey forecasts. For many series, the estimated  $\delta_I$  is negative, which implies forecasters overreact more when uncertainty is high. Indeed, the point estimates of  $\delta_I$  are negative for all series except for the 3-month T-bill rate. The estimated  $\delta_I$  is significantly negative for 7 out of 15 series at the 5 percent level and for 3 additional series at the 10 percent level. Those variables not only include NIPA variables such as nominal and real GDP, personal consumption, real nonresidential and residential investment, but also industrial production, unemployment rate, and 10-year treasury rate. Comparing the point estimates of  $\beta_I$  (unconditional forecast error predictability) with  $\gamma_I$  (forecast error predictability in normal times), for many variables, including nominal and real GDP, consumption, and industrial production,  $\gamma_I$  is less negative than  $\beta_I$ . This implies the estimated unconditional overreaction for those series is at least partially driven by strong overreaction during periods of high uncertainty.

In Appendix, we report additional regression results. First, we consider the macroeconomic uncertainty index based on a large number of macro time series by Jurado et al. (2015) instead of the cross-sectional dispersion of forecasts to identify high uncertainty episodes. Second, we perform aggressive treatments of outliers in the SPF data as advocated in Angeletos et al. (2021). In both extensions, our main empirical finding is unaffected: survey forecasts exhibit stronger overreaction during periods of high uncertainty.

**Theoretical analysis.** Summarizing, SPF forecasts exhibit (1) non-negative forecast error predictability at the consensus level, (2) overreaction at the individual level, and (3) stronger overreaction during periods of high uncertainty. We show that Smooth DE can explain all three properties, while standard DE can only explain (1) and (2).

We extend the setting in Bordalo et al. (2020) to allow for time-varying uncertainty. Consider forecasters who wish to forecast the  $h$ -period-ahead future values of  $y_t$ , where  $y_t$  is the sum of a hidden persistent component  $x_t$  and an i.i.d., temporary component  $\eta_t$ :

$$y_t = x_t + \eta_t, \quad \eta_t \sim N(0, \sigma_{\eta,t}^2),$$

where the volatility  $\sigma_{\eta,t}$  of the temporary component is time-varying and takes two values  $\sigma_{\eta,t} \in \{\sigma_{\eta}^L, \sigma_{\eta}^H\}$ , where  $\sigma_{\eta}^L < \sigma_{\eta}^H$ . All forecasters know the current realizations of  $\sigma_{\eta,t}$ . Forecaster  $i$  cannot observe the realization of  $x_t$  directly but receives a private noisy signal  $i$

$$s_{i,t} = x_t + \varepsilon_{i,t}, \quad \varepsilon_{i,t} \sim N(0, \sigma_{\varepsilon}^2),$$

where  $x_t$  follows an AR(1) process:  $x_t = \rho x_{t-1} + u_t$ , with  $u_t \sim N(0, \sigma_u^2)$ . Intuitively, forecasters filter out noise from their signals  $s_{i,t}$ , which would reflect noisy information or

Table 1: Forecast error on forecast revision regression coefficients

	(1)	(2)	(3)	(4)
	$\beta_C$	$\beta_I$	$\gamma_I$	$\delta_I$
Nominal GDP (NGDP)	0.25 (0.38)	-0.25** (0.11)	-0.12 (0.10)	-0.40** (0.17)
Real GDP (RGDP)	0.11 (0.33)	-0.25* (0.14)	-0.11 (0.10)	-0.36* (0.20)
GDP price index (PGDP)	1.52*** (0.44)	0.09 (0.14)	0.11 (0.16)	-0.13 (0.24)
CPI (CPI)	0.16 (0.23)	-0.47*** (0.18)	-0.47*** (0.18)	-0.47 (0.70)
Real consumption (RCONSUM)	-0.29 (0.29)	-0.51*** (0.18)	-0.21 (0.14)	-0.47** (0.22)
Real nonresidential investment (RNRESIN)	0.36 (0.47)	-0.22 (0.23)	0.03 (0.13)	-0.60* (0.34)
Real residential investment (RRESIN)	0.63 (0.46)	-0.20 (0.15)	-0.03 (0.11)	-1.06*** (0.26)
Real federal government consumption (RGF)	-0.39* (0.22)	-0.52*** (0.06)	-0.48*** (0.06)	-0.17 (0.14)
Real state and local govmnt consumption (RGSL)	0.15 (0.31)	-0.47*** (0.06)	-0.42*** (0.06)	-0.21** (0.10)
Industrial production (INDPROD)	0.55* (0.32)	-0.16* (0.10)	-0.06 (0.10)	-0.49*** (0.18)
Housing start (HOUSING)	0.19 (0.33)	-0.29*** (0.10)	-0.23** (0.11)	-0.35* (0.20)
Unemployment rate (UNEMP)	-0.08 (0.33)	-0.29 (0.21)	0.25** (0.13)	-0.88*** (0.16)
Three-month Treasury rate (TB3M)	0.78*** (0.23)	0.35*** (0.13)	0.29*** (0.11)	1.38*** (0.45)
Ten-year Treasury rate (TN10Y)	0.14 (0.16)	-0.14* (0.08)	-0.11 (0.08)	-0.67*** (0.18)
AAA corporate bond rate (AAA)	-0.03 (0.22)	-0.25*** (0.07)	-0.25*** (0.07)	-0.25 (0.26)

*Notes:* The table reports the estimates from the consensus and individual-level forecast error on forecast revision regressions. The first column reports the coefficient  $\beta_C$  in the consensus regression (23). The second column reports the coefficient  $\beta_I$  in the individual-level regression (23) and the third and fourth columns report the coefficients  $\gamma_I$  and  $\delta_I$  in the individual-level regression with uncertainty dummy (24). Standard errors, reported in parentheses, are Newey and West (1994) with automatic lag selection and, for individual-level regressions, clustered by forecaster and time.

\*\*\*Significant at the 1 percent level. \*\*Significant at the 5 percent level. \*Significant at the 10 percent level.

rational inattention about  $x_t$ . Given that  $y_t$  is the sum of the persistent component  $x_t$  and an i.i.d. shock  $\eta_t$ , a rational forecast of  $y_{t+h}$  is equal to the rational forecast of  $x_{t+h}$ .

Here we summarize the key results of the model and defer the details to Appendix G. Focusing on  $J = 1$  to maintain tractability, the Smooth DE forecast of  $y_{t+h}$  at period  $t$  is

$$\begin{aligned} y_{i,t+h|t}^\theta &= \rho^h \left[ x_{i,t|t-1} + \left( 1 + \tilde{\theta}_{t|t-1} \right) \frac{\Sigma}{\Sigma + \sigma_\varepsilon^2} (s_{i,t} - x_{i,t|t-1}) \right], \\ \tilde{\theta}_{t,t-1} &= \theta \frac{R_{t+h|t,t-1}}{1 + \theta (1 - R_{t+h|t,t-1})}, \\ R_{t+h|t,t-1} &= \frac{\mathbb{V}_t(y_{t+h})}{\mathbb{V}_{t-1}(y_{t+h})}, \end{aligned}$$

where  $x_{i,t|t-1}$  is the time  $t-1$  RE (Kalman filter) estimate of  $x_t$  by forecaster  $i$ ,  $\Sigma$  is the steady-state RE posterior variance of  $x_t$ , and  $\mathbb{V}_t(y_{t+h})$  is the time  $t$  RE conditional variance of  $y_{t+h}$ . Smooth DE forecasters update their beliefs about the hidden  $x_t$  with news  $(s_{i,t} - x_{i,t|t-1})$  in proportion to the Kalman gain  $\frac{\Sigma}{\Sigma + \sigma_\varepsilon^2}$  but they overreact relative to the Bayesian benchmark by  $\tilde{\theta}_{t|t-1}$ .<sup>11</sup> The effective overreaction  $\tilde{\theta}_{t|t-1}$  is larger in the high uncertainty state ( $\sigma_{\eta,t} = \sigma^H$ ) than in the low uncertainty state ( $\sigma_{\eta,t} = \sigma^L$ ) because in the high uncertainty state new information  $s_{i,t}$  reduces uncertainty about  $y_{t+h}$  less than in the low uncertainty state.

Three key results emerge. First, under Smooth DE, the cross-sectional standard deviation of forecasts  $y_{i,t+h|t}^\theta$  is larger when  $\sigma_{\eta,t} = \sigma^H$  compared to when  $\sigma_{\eta,t} = \sigma^L$  because forecasters overreact more to the private signals  $s_{i,t}$  when uncertainty is high. This result justifies our empirical strategy of identifying high uncertainty periods using the cross-sectional dispersion of forecasts. In contrast, this dispersion is constant under RE and standard DE. Second, the consensus regression coefficient  $\beta_C$  is non-negative as long as the forecasters' overreaction to their signals is not "too large." In this case, forecasters sufficiently discount their noisy signals so that consensus forecasts display rigidity. Third, while at the individual level the forecast error predictability is negative ( $\beta_I < 0$ ) both under standard DE and under Smooth DE, the error predictability becomes more negative during periods of high uncertainty ( $\delta_I < 0$ ) only under Smooth DE. Under standard DE the predictability is unchanged ( $\delta_I = 0$ ).

The predictability coefficient from the individual-level regression (23) is given by

$$\beta_I = \frac{\text{cov} \left( y_{t+h} - y_{i,t+h|t}^\theta, y_{i,t+h|t}^\theta - y_{i,t+h|t-1}^\theta \right)}{\text{var} \left( y_{i,t+h|t}^\theta - y_{i,t+h|t-1}^\theta \right)}. \quad (25)$$

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<sup>11</sup>In the Appendix we discuss in detail the signal extraction problem under Smooth DE.

Under Smooth DE, the variance and the co-variance is time-varying and is given by

$$\frac{cov_t \left( y_{t+h} - y_{i,t+h|t}^\theta, y_{i,t+h|t}^\theta - y_{i,t+h|t-1}^\theta \right)}{var_t \left( y_{i,t+h|t}^\theta - y_{i,t+h|t-1}^\theta \right)} = - \frac{\tilde{\theta}_{t,t-1} \left( 1 + \tilde{\theta}_{t,t-1} \right)}{\left( 1 + \tilde{\theta}_{t,t-1} \right)^2 + \left( \tilde{\theta}_{t-1,t-2} \rho \right)^2}. \quad (26)$$

(26) is negative for  $\tilde{\theta}_{t,t-1} > 0$ . Since the unconditional predictability (25) is a weighted average of the conditional predictability (26), we have  $\beta_I < 0$ . Next, (26) decreases as  $\tilde{\theta}_{t,t-1}$  increases. Thus the conditional predictability is more negative during periods of high uncertainty ( $\delta_I < 0$ ). Under standard DE, in contrast, the degree of overreaction and the conditional predictability does not vary across states ( $\delta_I = 0$ ).

## 5 Business cycle implications

We illustrate the business cycle implications of Smooth DE in a parsimonious RBC model with time-varying uncertainty. We argue that Smooth DE emerges as a novel behavioral propagation and amplification mechanism for time-varying uncertainty. We first show that the model replicates, without relying on additional frictions, several salient features of the data thanks to the state-dependent overreaction: (1) *asymmetry* (recessions are sharper than expansions), (2) *countercyclical micro volatility* (cross-sectional variances of microeconomic variables rise in recessions), and (3) *countercyclical macro volatility* (time-series variances of macroeconomic variables rise in recessions).

### 5.1 The model

To isolate the role of Smooth DE as a propagation mechanism, we abstract from conventional frictions in the uncertainty shock literature, such as adjustment costs (Bloom (2009), Bloom et al. (2018)) and sticky prices (Fernández-Villaverde et al. (2015), Basu and Bundick (2017), Bianchi et al. (2023)). The economy consists of a continuum of islands  $i \in [0, 1]$ . In each island  $i$ , an agent has the per-period utility function

$$U(c_{i,t}, h_{i,t}) = \frac{c_{i,t}^{1-\gamma}}{1-\gamma} - \beta \frac{h_{i,t}^{1+\eta}}{1+\eta}.$$

where  $c_{i,t}$  is consumption,  $h_{i,t}$  is the amount of hours worked,  $\gamma$  is the coefficient of relative risk aversion, and  $\eta$  is the inverse of the Frisch labor elasticity. We simplify the algebra below by multiplying the disutility of labor by the discount factor  $\beta$ .

Output in each island is produced according to  $y_{i,t} = z_{i,t} h_{i,t-1}$ . The  $t-1$  subscript on hours reflects the assumption that the labor input is chosen before the random realization of

productivity  $z_{i,t}$  is known. The island resource constraint is  $c_{i,t} = y_{i,t}$ . We obtain aggregate variables by adding up variables of all islands:

$$H_t = \int_0^1 h_{i,t} di, \quad Y_t = \int_0^1 y_{i,t} di, \quad C_t = \int_0^1 c_{i,t} di$$

The island productivity  $z_{i,t+1}$  is the sum of aggregate and idiosyncratic components:

$$\ln z_{i,t+1} = A_{t+1} + a_{i,t+1},$$

The economy-wide TFP shock  $A_{t+1}$  is common across all islands and follows the process

$$A_{t+1} = \rho_A A_t + u_{A,t+1}, \quad u_{A,t+1} \sim i.i.d.N(0, \sigma_A^2).$$

The idiosyncratic TFP  $a_{i,t+1}$  is instead specific to island  $i$ , and it is composed of a predictable component  $s_{i,t} \sim i.i.d.N(0, \sigma_s^2)$ , known one-period-in-advance, and an unpredictable component  $u_{a,i,t+1} \sim i.i.d.N(0, \sigma_{a,t}^2)$  realized at  $t + 1$ :  $a_{i,t+1} = s_{i,t} + u_{a,i,t+1}$ . Following Bloom et al. (2018), we assume the volatility  $\sigma_{a,t}$  is time-varying and negatively correlated with the economy-wide TFP. As we describe in Section 5.4,  $\sigma_{a,t}$  increases when there is a negative innovation to the economy-wide TFP, and vice versa. We use  $\sigma_{a,t}$  to denote the volatility of the period  $t + 1$  innovation to reflect the assumption that the volatility of the next period's innovation is known one-period-in-advance. We also assume that the volatility of the predictable component,  $s_{i,t}$ , is constant. This implies that the cross-sectional dispersion of labor is driven only by the news effect of the uncertainty shock. If we were to relax the assumption of constant volatility of  $s_{i,t}$ , the cross-sectional dispersion would also depend on its realized volatility, but none of the main qualitative properties of the model would change.

The mean and variance of  $a_{i,t+1}$  conditional on the predictable component  $s_{i,t}$  are

$$\mathbb{E}_{i,t}[a_{i,t+1}] = s_{i,t}, \quad \mathbb{V}_{i,t}[a_{i,t+1}] = \sigma_{a,t}^2.$$

We can define the residual uncertainty as in David et al. (2016) as  $\sigma_{a,t}^2/(\sigma_s^2 + \sigma_{a,t}^2)$ , which is increasing in  $\sigma_{a,t}^2$ . In times of low aggregate TFP and high uncertainty, the predictable component  $s_{i,t}$  serves as a weaker signal in forecasting  $a_{i,t+1}$  relative to times of low uncertainty.

## 5.2 Rational Expectations solution

We first characterize the equilibrium under RE. The island  $i$  agent's Bellman equation is

$$\mathcal{V}(h_{i,t-1}, z_{i,t}) = \max_{h_{i,t}} \{U(c_{i,t}, h_{i,t}) + \beta \mathbb{E}_{i,t} [\mathcal{V}(h_{i,t}, z_{i,t+1})]\}.$$

Combining the first order condition for labor with the envelope condition, we obtain

$$(h_{i,t})^\eta = \mathbb{E}_{i,t} [(c_{i,t+1})^{-\gamma} z_{i,t+1}]. \quad (27)$$

The optimality condition equates the current marginal disutility of working with its expected benefit. The latter is given by the marginal product of labor weighted by the marginal utility of consumption. We log-linearize the condition and use the method of undetermined coefficients to obtain the RE solution. Hats denote log-deviations from steady state.

**Proposition 3** *The equilibrium under RE is given as follows:*

1. Individual hours worked are given by  $\hat{h}_{i,t} = \varepsilon [\rho_A A_t + s_{i,t}]$ , where  $\varepsilon = \frac{1-\gamma}{\eta+\gamma}$ . Equilibrium output and consumption follow immediately as  $\hat{y}_{i,t} = A_t + a_{i,t} + \hat{h}_{i,t-1} = \hat{c}_{i,t}$ .
2. Equilibrium aggregate variables are given by  $\hat{H}_t = \varepsilon \rho_A A_t$ ,  $\hat{Y}_t = A_t + \hat{H}_{t-1} = \hat{C}_t$

**Proof.** See Appendix. ■

The response of individual and aggregate hours to news about expected economy-wide productivity  $\rho_A A_t$  and island-specific productivity  $s_{i,t}$  is affected by the intertemporal elasticity of consumption (IES). When the IES is large enough ( $\gamma^{-1} > 1$ ), an increase in expected productivity raises hours ( $\varepsilon > 0$ ). In that case, the intertemporal substitution effect dominates the wealth effect that would lower hours through the effect on marginal utility.

The next proposition characterizes the cross-sectional variance under RE.

**Proposition 4** *The cross-sectional variance of hours worked is given by*

$$\int_0^1 (\hat{h}_{i,t} - \hat{H}_t)^2 di = \left[ \frac{1-\gamma}{\eta+\gamma} \right]^2 \sigma_s^2,$$

*and is constant over the business cycle. The cross-sectional variances of output  $y_{i,t}$  and consumption  $c_{i,t}$  are increasing in the volatility  $\sigma_{a,t-1}^2$  of the idiosyncratic TFP.*

**Proof.** See Appendix. ■

Under RE, the cross-sectional variance of hours stays constant over the business cycle. This is because once the model is linearized, the news effect of changes in uncertainty is muted under RE. The cross-sectional variances of output and consumption are instead mechanically affected by  $\sigma_{a,t-1}^2$  because of the change in realized volatility.



### 5.3 Smooth DE solution

We now solve the model under Smooth DE. We consider the case of distant memory, meaning that agents' memory recall is based on a more distant past, rather than just the immediate past. This means that the reference group is based on the information set available  $J > 1$  periods ago. Bianchi et al. (2024) find that in standard models, distant memory can account for salient features of data, such as persistence and repeated boom-bust cycles. Under distant memory, a time-inconsistency problem arises due to the failure of the law of iterated expectations. Bianchi et al. (2024) address this issue by adopting the *naïveté* approach (O'Donoghue and Rabin (1999)), which we follow here. Under this approach, the agent fails to take into account that her preferences are time-inconsistent and thinks that in the future she will make choices under perfect memory recall, or RE. However, when the future arrives, the agent ends up changing behavior and be again subject to her imperfect memory recall.<sup>12</sup>

Let  $\theta$ -superscripts and  $RE$ -superscripts denote equilibrium Smooth DE choices and choices under a RE policy function, respectively. The island  $i$  agent's Bellman equation is

$$\max_{h_{i,t}^\theta} \{U(c_{i,t}^\theta, h_{i,t}^\theta) + \beta \mathbb{E}_{i,t}^\theta [\mathcal{V}(h_{i,t}^\theta, z_{i,t+1})]\},$$

subject to  $y_{i,t}^\theta = z_{i,t} h_{i,t-1}^\theta$  and  $c_{i,t}^\theta = y_{i,t}^\theta$ . The continuation value is given by

$$\mathcal{V}(h_{i,t-1}^\theta, z_{i,t}) = \max_{h_{i,t}^{RE}} \{U(c_{i,t}^{RE}, h_{i,t}^{RE}) + \beta \mathbb{E}_{i,t} [\mathcal{V}(h_{i,t}^{RE}, z_{i,t+1})]\},$$

subject to  $y_{i,t}^{RE} = z_{i,t} h_{i,t-1}^\theta$  and  $c_{i,t}^{RE} = y_{i,t}^{RE}$ .

Similar to the RE problem, the agent optimally equates the marginal disutility of labor with its expected benefit, except that the benefit is evaluated under Smooth DE:

$$(h_{i,t}^\theta)^\eta = \mathbb{E}_{i,t}^\theta \left[ (c_{i,t+1}^{RE})^{-\gamma} z_{i,t+1} \right]. \quad (28)$$

**Proposition 5** *The equilibrium under Smooth DE is given as follows:*

1. *Individual hours worked are given by*

$$\begin{aligned} \widehat{h}_{i,t}^\theta &= \varepsilon [\rho_A A_t + s_{i,t}] \\ &+ \frac{\widetilde{\theta}_{t,t-J} \eta}{\eta + \left(1 + \widetilde{\theta}_{t,t-J}\right) \gamma} \varepsilon [\rho_A \mathbb{N}_{t-J,t} [A_t] + s_{i,t}], \end{aligned} \quad (29)$$

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<sup>12</sup>Bianchi et al. (2024) further argue that the naïveté approach is psychologically coherent and consistent with the underlying foundation of diagnostic beliefs as a heuristic and a mental short-cut.

where  $\varepsilon$  is given in Proposition 3 and  $\mathbb{N}_{t-J,t}[A_t] \equiv A_t - \mathbb{E}_{t-J}[A_t]$  represents the news in  $A_t$ , compared to past expectation. Equilibrium output and consumption follow as

$$\hat{y}_{i,t}^\theta = A_t + a_{i,t} + \hat{h}_{i,t-1}^\theta = \hat{c}_{i,t}^\theta. \quad (30)$$

2. The effective diagnosticity parameter  $\tilde{\theta}_{t,t-J}$  is given by

$$\tilde{\theta}_{t,t-J} = \frac{R_{t+1|t,t-J}\theta}{1 + (1 - R_{t+1|t,t-J})\theta}, \quad (31)$$

where

$$R_{t+1|t,t-J} = \frac{\mathbb{V}_{i,t}(-\gamma\hat{c}_{i,t+1}^{RE} + A_{t+1} + a_{i,t+1})}{\mathbb{V}_{i,t-J}(-\gamma\hat{c}_{i,t+1}^{RE} + A_{t+1} + a_{i,t+1})}. \quad (32)$$

3. Equilibrium aggregate variables are given by

$$\begin{aligned} \hat{H}_t^\theta &= \varepsilon\rho_A A_t + \frac{\tilde{\theta}_{t,t-J}\eta}{\eta + (1 + \tilde{\theta}_{t,t-J})\gamma} \varepsilon\rho_A \mathbb{N}_{t-J,t}[A_t] \\ \hat{Y}_t^\theta &= A_t + \hat{H}_{t-1}^\theta = \hat{C}_t^\theta \end{aligned} \quad (33)$$

**Proof.** See Appendix. ■

First, consider the policy function for individual hours  $h_{i,t}^\theta$ . The first line of (29) is identical to the RE policy function. The second line captures the overreaction to news, i.e. surprises.<sup>13</sup> Consider, a positive surprise to the economy-wide TFP  $A_t$ . Smooth diagnostic agents are over-influenced by this surprise and become over-optimistic about the future benefit of working, and hence work more (if  $\varepsilon > 0$ ). The coefficient on this overreaction,  $\frac{\tilde{\theta}_{t,t-J}\eta}{\eta + (1 + \tilde{\theta}_{t,t-J})\gamma}$ , is increasing in the effective diagnosticity  $\tilde{\theta}_{t,t-J}$ . From (30) individual output and consumption also overreact when individual hours overreact. Second, the effective diagnosticity  $\tilde{\theta}_{t,t-J}$  is positively related to  $R_{t+1|t,t-J}$ , given by (32): the ratio between the current uncertainty about the marginal benefit of labor and the uncertainty perceived at period  $t - J$ . Third, aggregate hours, output, and consumption also feature overreaction, controlled by  $\tilde{\theta}_{t,t-J}$ , to news about economy-wide shocks.

The expressions (31) and (32) in Proposition 5 suggest that an increase in uncertainty about future idiosyncratic productivity could raise  $\tilde{\theta}_{t,t-J}$  and, in turn, the overreaction to news.<sup>14</sup> The Proposition below indeed confirms that this is the case.

<sup>13</sup>Note that, for  $s_{i,t}$ , since it is i.i.d., the surprise is  $s_{i,t}$  itself.

<sup>14</sup>In the current model, we must take a stance on how agents deal with time-varying volatility when forming expectations. There are two approaches to compute the conditional variance at  $t - J$  in (32) that preserve normality of the Smooth DE density. The first approach consists of making an “anticipated

**Proposition 6** *An increase in the volatility  $\sigma_{a,t}^2$  of idiosyncratic TFP raises the effective diagnosticity parameter  $\tilde{\theta}_{t,t-J}$ .*

**Proof.** See Appendix. ■

There are two important implications of this proposition. First, *the business cycle is asymmetric*, even if the underlying shocks are symmetric. A positive TFP shock would lower uncertainty and, as result, overreaction. In contrast, a negative TFP shock would raise uncertainty and, as result, overreaction. Thus, a drop in economic activity in response to a negative shock would be sharper, while an expansion in response to a symmetric positive shock would be milder, generating asymmetric fluctuations. Second, *macroeconomic volatility is countercyclical*. During expansions uncertainty and overreaction are low while in recessions agents overreact more to economy-wide shocks.

State-dependent overreaction also implies that micro-level volatility is countercyclical:

**Proposition 7** *The cross-sectional variance of hours worked is given by*

$$\int_0^1 \left( \hat{h}_{i,t}^\theta - \hat{H}_t^\theta \right)^2 di = \left[ \frac{(1 + \tilde{\theta}_{t,t-J})(1 - \gamma)}{\eta + (1 + \tilde{\theta}_{t,t-J})\gamma} \right]^2 \sigma_s^2,$$

*and is increasing in  $\tilde{\theta}_{t,t-J}$  and, thus, in the volatility  $\sigma_{a,t}^2$  of the idiosyncratic TFP. The cross-sectional variances of output  $y_{i,t}$  and consumption  $c_{i,t}$  are similarly increasing in the volatility  $\sigma_{a,t-1}^2$  of the idiosyncratic TFP.*

**Proof.** See Appendix. ■

As uncertainty increases, the overreactions to the predictable component of idiosyncratic TFP and the future benefit of labor, captured in the  $\left[ \frac{(1 + \tilde{\theta}_{t,t-J})(1 - \gamma)}{\eta + (1 + \tilde{\theta}_{t,t-J})\gamma} \right]^2$  term, rise. Hence, an increase in uncertainty about idiosyncratic TFP raises the cross-sectional variances of individual actions.

Our theory has an important policy implication. As we saw above, the micro-level volatility and macroeconomic volatility are tightly linked through the state-dependent overreaction controlled by  $\tilde{\theta}_{t,t-J}$ . Thus, a policy that reduces microeconomic uncertainty through, for instance, a redistributive tax policy can also be effective in stabilizing the macroeconomy. To fix ideas, consider a progressive income tax and subsidy scheme where the individual rate  $\tau_{i,t}$  is increasing in the realized idiosyncratic productivity level  $\tau_{i,t} = \tau a_{i,t}$ , where  $\tau \geq 0$  is a parameter that controls the progressivity. The island resource constraint is  $c_{i,t} + \tau_{i,t} y_{i,t} = y_{i,t}$ ,

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utility” assumption (Kreps (1998)). In this case, agents’ uncertainty depends on the volatility at the time of the forecast, disregarding the possibility of volatility changes. The second approach consists of assuming that agents take into account the possibility of volatility changes, but that memory retrieves a Normal approximation of the resulting mixture of Normal’s. We adopt the first approach, as it is arguably more consistent with the naïveté assumption and the general motivation of DE as a mental heuristics.

so the agent pays a tax ( $\tau_{i,t} > 0$ ) if the realized TFP shock is positive ( $a_{i,t} > 0$ ) and receives a transfer ( $\tau_{i,t} < 0$ ) otherwise. The scheme is budget neutral.

**Proposition 8** *A higher progressivity  $\tau$  is associated with a smaller increase in the effective diagnosticity parameter  $\tilde{\theta}_{t,t-J}$  when the volatility  $\sigma_{a,t}^2$  of idiosyncratic TFP rises.*

**Proof.** See Appendix. ■

Intuitively, redistribution dampens the state-dependent overreaction by reducing cross-sectional uncertainty about the future benefit of labor. Thus, the government can stabilize the macroeconomy by using the tax policy to reduce the increase in uncertainty and overreaction. For instance, in times of low aggregate TFP and high uncertainty, the government can implement the tax policy or increase its progressivity. These interventions would dampen the overreaction and make the downturn less severe.

## 5.4 Quantitative application

We illustrate the quantitative potential of the Smooth DE mechanism in the context of the parsimonious RBC model presented above by examining its dynamics.

**Calibration.** We calibrate the model to a quarterly frequency. We set the discount factor  $\beta = 0.99$ , the IES  $\gamma^{-1} = 0.25^{-1}$ , and  $\eta = 0.4$ , implying a Frisch elasticity of 2.5.<sup>15</sup> For the economy-wide TFP shock, we set  $\rho_A = 0.95$  and  $\sigma_A = 0.7/100$ . The calibration satisfies the condition  $\gamma^{-1} > 1$ , so labor increases in response to an increase in expected TFP.

Consider the time-varying standard deviation  $\sigma_{a,t}$  of the idiosyncratic TFP shocks. Using Census micro data, Bloom et al. (2018) and Ilut et al. (2018) find that, during recessions, the dispersion of TFP shocks increases by 13% and 7%, respectively. Motivated by these findings, we assume that a *negative* innovation to economy-wide TFP larger or equal than one standard deviation is associated with a 10% increase in the standard deviation  $\sigma_{a,t}$  of the idiosyncratic TFP shocks relative to the steady-state standard deviation  $\sigma_a$ . Conversely, a *positive* economy-wide TFP innovation of the same magnitude is associated with a 10% decrease in the standard deviation  $\sigma_{a,t}$  of the idiosyncratic TFP shocks.

We assume that the agent's comparison group is the expectation formed  $J = 5$  periods ago. The parameter  $J$  mainly determines the persistence of overreaction and the value is consistent with Bianchi et al. (2024), who find that in an estimated structural model the memory weights center around five- and six-quarters-ago expectations.

There are three remaining parameters: the steady-state standard deviation of the unpredictable component of the idiosyncratic TFP shock  $\sigma_a$ , the standard deviation of the

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<sup>15</sup>These values of IES and Frisch elasticity allow us to generate realistic labor volatility. Our calibrated model generates the time-series standard deviation of aggregate hours worked of 1.67%. In the data, the standard deviation of total hours worked in the nonfarm business sector (1983:Q1–2019:Q4) is 1.66%.

Table 2: Internally calibrated parameters and targeted moments

Parameters		Targeted moments		
			Data	Model
$\sigma_a$	0.022	Realized absolute forecast error	0.143	0.143
$\sigma_s$	0.027	Residual uncertainty	0.41	0.41
$\tilde{\theta}$	1.547	Skewness of aggregate hours	-0.21	-0.21

*Notes:* The table reports the parameters and their calibrated values as well as the targeted moments.

predictable component of the idiosyncratic TFP shock  $\sigma_s$ , and the diagnosticity parameter  $\theta$ . We calibrate these parameters to match the three empirical moments summarized in Table 2. While multiple model parameters jointly affect these moments, we select the moments so that each moment is mostly informative about a parameter of interest. The first empirical moment, the mean of realized absolute forecast errors, is from Barrero (2022) who uses survey data on US managers. Forecast errors are computed by subtracting realized sales growth between  $t$  to  $t + 4$  from managers' forecasts. The model counterpart is obtained by calculating the mean absolute forecast error on the simulated distribution of the realized forecast error  $\mathbb{E}_{i,t}^{\theta} [\hat{y}_{i,t+4}^{RE}] - \hat{y}_{i,t+4}^{\theta}$ .<sup>16</sup> This moment is informative about the steady-state standard deviation of the unpredictable component of idiosyncratic TFP.

The second moment, residual uncertainty, captures the amount of posterior uncertainty relative to the ex-ante uncertainty. David et al. (2016) estimate the residual uncertainty to be 41%. The model counterpart is given by  $\sigma_a^2 / (\sigma_s^2 + \sigma_a^2)$ . This moment is useful to pin down the standard deviation  $\sigma_s$  of the predictable component of idiosyncratic TFP.

Finally, the third moment is the skewness of total hours worked in the nonfarm business sector (1983:Q1–2019:Q4).<sup>17</sup> The negative skewness (−0.21) reflects macroeconomic asymmetry: drops in hours worked are steeper than increases. In our model, a negative economy-wide TFP innovation increases uncertainty  $\sigma_{a,t}^2$  and, in turn, the effective overreaction  $\tilde{\theta}_{t,t-J}$ . A positive TFP innovation, in contrast, reduces overreaction. Under Smooth DE, the diagnosticity parameter  $\theta$  governs the strength of this mechanism to generate asymmetry. Under RE model and the standard DE model where the overreaction is constant, there is no asymmetry, and the skewness is zero.

<sup>16</sup>Specifically, we generate 100 replications of  $T = 200$  time series with  $n = 500$  islands. The number of islands roughly matches the the number of firms surveyed in the SBU data in Barrero (2022).

<sup>17</sup>The empirical skewness of hours increases significantly to −1.75 when we extend the sample until 2022:Q1 to include the 2020 Covid-19 recession. We use the simulated data to compute the skewness of aggregate hours worked in the model. Both simulated and actual time series are HP-filtered with  $\lambda = 1600$ .

Table 3: Untargeted survey moments: overreaction and overconfidence

	(1)	(2)	(3)	(4)
	$F_t(\Delta y_{i,t+4 t}) - \Delta y_{i,t+4 t}$	Absolute forecast error		
	on $\Delta y_{i,t t-1}$	Realized	Subjective	(Subjective)/(Realized)
Data	0.173 (0.059)	0.143 (0.012)	0.023 (0.002)	0.16
Model	0.095	0.143	0.017	0.12

*Notes:* The table reports the coefficient on overextrapolation and realized and subjective mean absolute forecast errors. The data moments are computed by Barrero (2022) using survey data on US managers, with observations employment-weighted and standard errors in parentheses. The model moments are calculated using the simulated data from the Smooth DE model.

The model moments match the empirical moments perfectly. The calibrated  $\sigma_a$  and  $\sigma_s$  imply the predictable and unpredictable components' variances are about the same in steady state. The long-run average effective diagnosticity parameter  $\tilde{\theta}$ , implied by the calibrated value of  $\theta$ , is 1.54. This value is somewhat larger than Bordalo et al. (2018), Bordalo et al. (2024), and d'Arienzo (2020), which tend to estimate the standard DE diagnosticity parameter around 1, but smaller than the estimate of 1.97 in Bianchi et al. (2024).<sup>18</sup>

**Implications for untargeted survey moments.** We examine to what extent our model can explain untargeted survey evidence on overreaction and overconfidence. We use Barrero (2022)'s survey moments as an external validation because the study shows both overreaction and overconfidence based on a single dataset (SBU). The first column of Table 3 reports the coefficient from a panel regression where managers' time  $t$  forecast of  $t+4$  sales growth minus the realization is regressed on the sales growth between quarter  $t-1$  to  $t$ . The coefficient is positive, meaning that managers' forecasts tend to be excessively optimistic during high growth periods. The second column is the realized mean absolute forecast error (MAFE), reported in Table 2, shown here to facilitate comparison. The third column is the subjective mean absolute forecast error, where the hypothetical realizations are drawn from the managers' subjective probability distributions. The fourth column shows that subjective MAFE is only 16% the size of the realized errors, indicating overconfidence.

The model moments are computed by simulating the model under Smooth DE. First, consider the overextrapolation regression coefficient. The model counterpart is the coefficient on pooled OLS where we regress the Smooth DE four-quarters-ahead forecast error,

<sup>18</sup>Like Bianchi et al. (2024), our current model features distant memory ( $J > 1$ ). Bianchi et al. (2024) notes that existing estimates are based primarily on models where imperfect memory is assumed to be driven only by the immediate past ( $J = 1$ ), and this assumption changes inference about the diagnosticity parameter.

$\mathbb{E}_{i,t}^\theta [\hat{y}_{i,t+4}^{RE}] - \hat{y}_{i,t+4}^\theta$ , on output growth,  $[\hat{y}_{i,t}^\theta - \hat{y}_{i,t-1}^\theta]$ , which proxies for news. The coefficient is positive, but smaller than in the data. The calibrated model understates this coefficient relative to the data because in the model economy-wide shocks are persistent, while island-specific shocks are i.i.d. In contrast to persistent shocks, when shocks are i.i.d., the Smooth DE forecasts are orthogonal to news, so the idiosyncratic shocks push the coefficient toward zero.<sup>19</sup> While we specified idiosyncratic TFP shocks to be i.i.d. for tractability, allowing for persistence would increase the overextrapolation coefficient. Thus, our model provides a conservative lower bound on the macroeconomic effects of Smooth DE.

Next, consider the mean absolute forecast errors. The subjective error (third column) is obtained first by calculating the Smooth DE variance of output growth

$$\mathbb{V}_{i,t}^\theta [\hat{y}_{i,t+4}^{RE}] = \frac{\mathbb{V}_{i,t} [\hat{y}_{i,t+4}^{RE}]}{1 + (1 - R_{t+1|t,t-J}) \theta}, \quad (34)$$

and then leverage the normality of the RE output growth so that the subjective absolute forecast error is given by  $\sqrt{2/\pi} (\mathbb{V}_{i,t}^\theta [\hat{y}_{i,t+4}^{RE}])^{\frac{1}{2}}$ . The model closely matches the subjective forecast error. The size of the absolute subjective error is 12% of the size of the realized forecast error (fourth column), in line with the survey data's 16%. According to (34), the Smooth DE variance  $\mathbb{V}_{i,t}^\theta [\hat{y}_{i,t+4}^{RE}]$  would be lower than the econometrician's variance  $\mathbb{V}_{i,t} [\hat{y}_{i,t+4}^\theta]$  due to two factors. The first factor is that, under *naïveté*, Smooth DE agents perceive future output to follow the RE law of motion  $\hat{y}_{i,t+4}^{RE}$  instead of the equilibrium law of motion  $\hat{y}_{i,t+4}^\theta$ . The second factor is the Smooth DE effect (the denominator in (34)) on uncertainty, according to which a reduction of uncertainty contributes to overconfidence about the precision of expectations. To disentangle these two factors, we calculate the subjective mean absolute forecast error without the Smooth DE effect. We obtain  $\sqrt{2/\pi} (\mathbb{V}_{i,t} [\hat{y}_{i,t+4}^{RE}])^{\frac{1}{2}} = 0.053$ , which is 37% of the size of the realized errors. This ratio is more than double the values recovered by the data (16%) and implied by the baseline model (12%). We conclude that the Smooth DE effect is important to account for overconfidence as observed in survey data.

**Countercyclical micro and macro volatility.** We now study the model's ability to generate countercyclical micro and macro volatility. First, consider the micro volatility. In Panel A of Table 4, we report the ratio of the cross-sectional standard deviation of labor growth during recessions to the cross-sectional standard deviation during expansions. The first column shows this ratio from the data, as reported by Ilut et al. (2018), where recessions and expansions are defined as NBER recessions and NBER expansions, respectively. The cross-sectional dispersion is countercyclical: in recessions, it is 16% higher than during ex-

<sup>19</sup>This need not be the case when agents forecast endogenous variables in models with slow-moving endogenous states, such as capital. See Bianchi et al. (2024) for details.

Table 4: Countercyclical micro and macro volatility

	(1)	(2)	(3)	(4)
	Data	Smooth DE	DE	RE
A. Cross-sectional standard deviation of labor growth (Recessions)/(Expansions)	1.16	1.12	1	1
B. Volatility of aggregate labor growth (Recessions)/(Expansions)	1.23	1.22	1	1

*Notes:* Panel A reports the ratio of the cross-sectional standard deviation of labor growth during recessions and during expansions. Panel B reports the ratio of the rolling standard deviation of aggregate labor growth during recessions to the rolling standard deviation during expansions.

pansions. The second column reports the ratio in our model, where we define recessions and expansions as periods when there are one-standard-deviation negative and positive innovations to the economy-wide TFP, respectively. Under Smooth DE the cross-sectional standard deviation of labor growth is 12% higher during recessions than in expansions, so the model explains 75% of the empirical countercyclical volatility of micro volatility. In the model, a negative aggregate TFP innovation triggers an increase in idiosyncratic TFP uncertainty  $\sigma_{a,t}$ . As a result, the overreaction  $\tilde{\theta}_{t,t-J}$  to the predictable component  $s_{i,t}$  of idiosyncratic TFP rises, so the cross-sectional dispersion of actions such as labor increases. As shown in the third and the fourth columns, the cross-sectional dispersion is constant under the standard DE model, where the overreaction is constant, and the RE model, where we have  $\theta = 0$ .

Next, consider macro volatility. In our model, in times of low TFP and high idiosyncratic uncertainty  $\sigma_{a,t}$ , aggregate labor responds more to economy-wide shocks because overreaction is stronger. Panel B of Table 4 examines to what extent this countercyclical macro volatility is consistent with the data. To measure time-varying volatility of aggregate hours worked in the data, we compute the rolling window standard deviation as (Ilut et al. (2018)):

$$\sigma_{H,t} = \sqrt{\frac{1}{n_w - 1} \sum_{k=-(n_w-1)/2}^{(n_w-1)/2} (\Delta \ln H_{t+k} - \overline{\Delta \ln H_t})^2}, \quad (35)$$

where  $\Delta \ln H_{t+k}$  is the log change of total hours worked in the nonfarm business sector from a quarter  $t+k-1$  to  $t+k$  and  $\overline{\Delta \ln H_t} \equiv (1/n_w) \sum_{k=-(n_w-1)/2}^{(n_w-1)/2} \Delta \ln H_{t+k}$ . We set the window size  $n_w = 3$  and consider the sample 1983:Q1-2019:Q4. The first column reports the measured  $\sigma_{H,t}$  during NBER recessions relative to  $\sigma_{H,t}$  during NBER expansions. The measured volatility of aggregate labor growth is 23% higher in recessions than in expansions. We then compute the same rolling standard deviation on data simulated from the model. The



second column shows that in the model, the aggregate labor growth volatility is 22% higher in recessions than in expansions. Thus, the Smooth DE model generates countercyclical macro volatility quantitatively in line with the data, even if the volatility of economy-wide shocks is constant. DE and RE models, in contrast, do not generate countercyclical volatility.

## 6 Conclusion

We developed a tractable and structural bridge from the representativeness heuristic of Kahneman and Tversky (1972) to the time-series domain. We built on the formalization of representativeness by Gennaioli and Shleifer (2010) and of diagnostic expectations (DE) by Bordalo et al. (2018) to allow for what we call “smooth diagnosticity.” Under Smooth DE new information is defined as the difference between the current information set and a previous information set. A critical consequence of this basic approach is that current and past uncertainty interact to determine the intensity of the DE overreaction, but also create the preconditions for novel properties such as over- and under- confidence.

After formally characterizing Smooth DE and its key properties, we leveraged its insights along two substantive directions. First, we showed that Smooth DE implies a joint and parsimonious micro-foundation for key properties of survey data: overreaction to news, stronger overreaction for longer forecast horizons, overconfidence in subjective uncertainty, and a new stylized fact documented in this paper, namely that overreaction is stronger when uncertainty is high. Second, we embedded Smooth DE in a parsimonious RBC model with time-varying uncertainty. This model can account for survey data on overreaction and overconfidence as well as three salient properties of the business cycle: (1) asymmetry, (2) countercyclical micro volatility, and (3) countercyclical macro volatility. We also uncovered a novel policy implication: a redistributive policy that reduces idiosyncratic uncertainty could be beneficial for macroeconomic stabilization because it dampens the state-dependent overreaction.

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## Appendix

### A Proof of Proposition 1

Expression (9) can be written as:

$$f_t^\theta(\hat{x}_{t+1}) \propto \exp \left[ -\frac{1}{2\sigma_{t+h|t}^2} (x_{t+1} - \mu_{t+1|t})^2 \right] \left[ \frac{\exp \left[ -\frac{1}{2\sigma_{t+1|t}^2} (x_{t+1} - \mu_{t+1|t})^2 \right]}{\exp \left[ -\frac{1}{2\sigma_{t+1|t-J}^2} (x_{t+1} - \mu_{t+1|t-J})^2 \right]} \right]^\theta \frac{1}{Z}$$

Collecting the terms in the exponents, we get:

$$f_t^\theta(\hat{x}_{t+1}) \propto \exp \left[ -\frac{1}{2\sigma_{t+1|t}^2} \left[ (1 + \theta) (x_{t+1} - \mu_{t+1|t})^2 - \frac{\sigma_{t+1|t}^2}{\sigma_{t+1|t-J}^2} \theta (x_{t+1} - \mu_{t+1|t-J})^2 \right] \right] \frac{1}{Z}$$

Developing the squared terms and keeping track of the terms involving  $x_{t+1}$ , we obtain:

$$f_t^\theta(\hat{x}_{t+1}) \propto \exp \left[ \left[ x_{t+1}^2 - 2x_{t+1} \left( 1 + \theta - \frac{\sigma_{t+1|t}^2}{\sigma_{t+1|t-J}^2} \theta \right)^{-1} \left( \mu_{t+1|t} (1 + \theta) - \frac{\sigma_{t+1|t}^2}{\sigma_{t+1|t-J}^2} \theta \mu_{t+1|t-J} \right) \right] \right] \frac{1}{Z}$$

where the remaining terms are absorbed in the constant of integration.

Define:  $R_{t+1|t,t-J} \equiv \frac{\sigma_{t+1|t}^2}{\sigma_{t+1|t-J}^2}$ . If  $R_{t+1|t,t-J} > (1 + \theta)/\theta$ , the expression above corresponds to the kernel of a normal with mean:

$$\begin{aligned}\mathbb{E}_t^\theta(x_{t+1}) &= \left(1 + \theta - \frac{\sigma_{t+1|t}^2}{\sigma_{t+1|t-J}^2}\theta\right)^{-1} \left[\mu_{t+1|t}(1 + \theta) - \frac{\sigma_{t+1|t}^2}{\sigma_{t+1|t-J}^2}\theta\mu_{t+1|t-J}\right] \\ &= \left[\mu_{t+1|t} + \frac{R_{t+1|t,t-J}\theta}{1 + (1 - R_{t+1|t,t-J})\theta}(\mu_{t+1|t} - \mu_{t+1|t-J})\right]\end{aligned}$$

and variance:

$$\begin{aligned}\mathbb{V}_t^\theta(x_{t+1}) &= \sigma_{t+1|t}^2 \left(1 + \theta - \frac{\sigma_{t+1|t}^2}{\sigma_{t+1|t-J}^2}\theta\right)^{-1} \\ &= \frac{\sigma_{t+1|t}^2}{1 + (1 - R_{t+1|t,t-J})\theta}.\end{aligned}$$

This gives us the result stated in Proposition 2.

## B Upper bound on DE distortion

Suppose that we are interested in imposing an upper bound on the Smooth DE distortion. Imposing such upper bound on the overreaction in the mean guarantees that both distortions remain finite and non-decreasing as the ratio  $R_{t+h|t,t-J}$  goes to infinity. Thus, we propose the following approach.

Let  $\bar{\theta}$  be the desired upper bound of effective overreaction in conditional mean. By effective overreaction we refer to the object defined in equation (14). As a first step, we exploit the fact that the size of the distortion is increasing in  $R_{t+h|t,t-J}$  to find the threshold value  $\bar{R}$ , such that, for a given  $\theta$ , for each  $R_{t+h|t,t-J} > \bar{R}$ , the overreaction in the mean would be larger than  $\bar{\theta}$ :

$$\frac{\bar{R}\theta}{1 + \theta(1 - \bar{R})} = \bar{\theta}$$

It follows that the upper threshold in terms of  $R_{t+h|t,t-J}$  is

$$\bar{R} = \frac{\bar{\theta}}{1 + \bar{\theta}} \frac{1 + \theta}{\theta}$$

Whenever  $R_{t+h|t,t-J} > \bar{R}$ , we thus replace  $\theta$  with  $\theta_R$ , the value of  $\theta$  such that the overre-

action in the mean is equal to  $\bar{\theta}$ . Thus, we solve:

$$\frac{R_{t+h|t,t-J}\theta_R}{1 + \theta_R(1 - R_{t+h|t,t-J})} = \bar{\theta}$$

and obtain:

$$\theta_R = \frac{\bar{\theta}}{R_{t+h|t,t-J} - \bar{\theta}(1 - R_{t+h|t,t-J})}$$

Plugging in  $\theta_R$  in the formulas for the overreaction in mean and variance, we obtain:

$$\begin{aligned}\mathbb{E}_t^\theta(x_{t+h}) &= \mu_{t+h|t} + \theta_R \frac{R_{t+h|t,t-J}}{1 + \theta_R(1 - R_{t+h|t,t-J})} (\mu_{t+h|t} - \mu_{t+h|t-J}) \\ \mathbb{E}_t^\theta(x_{t+h}) &= \mu_{t+h|t} + \bar{\theta} (\mu_{t+h|t} - \mu_{t+h|t-J})\end{aligned}$$

and

$$\begin{aligned}\mathbb{V}_t^\theta(x_{t+h}) &= \frac{1}{1 + \theta_R(1 - R_{t+h|t,t-J})} \sigma_{t+h|t}^2 \\ \mathbb{V}_t^\theta(x_{t+h}) &= \left[ 1 + \bar{\theta} \left( 1 - \frac{1}{R_{t+h|t,t-J}} \right) \right] \sigma_{t+h|t}^2\end{aligned}$$

Note that while the overreaction in the mean remains constant once  $R_{t+h|t,t-J} > \bar{R}$ , the overreaction in the variance keeps growing as relative uncertainty increases, but it converges to a finite value:

$$\lim_{R_{t+h|t,t-J} \rightarrow \infty} \mathbb{V}_t^\theta(x_{t+h}) = \left[ 1 + \bar{\theta} \right] \sigma_{t+h|t}^2$$

## C Overreaction to new information and Smooth DE

To further understand Smooth DE, we rewrite the distorted conditional mean and variance in Proposition 1 as a function of the revised information, as follows.

**Corollary 3** (*A revision representation*). *The Smooth DE density of Proposition 1 can be*

represented as distorting the RE revisions in conditional mean and variance, as follows:

$$\begin{aligned}
\underbrace{\mathbb{E}_t^\theta(x_{t+h}) - \mu_{t+h|t-J}}_{\text{Smooth DE revision}} &= \underbrace{(\mu_{t+h|t} - \mu_{t+h|t-J})}_{\text{RE revision}} \underbrace{(1 + \theta)}_{\text{BGS effect}} \underbrace{[1 + \theta(1 - R_{t+h|t,t-J})]^{-1}}_{\text{Smooth DE effect}} \\
\\
\underbrace{\frac{\mathbb{V}_t^\theta(x_{t+h})}{\sigma_{t+h|t-J}^2}}_{\text{Smooth DE revision}} &= \underbrace{\frac{\sigma_{t+h|t}^2}{\sigma_{t+h|t-J}^2}}_{\text{RE revision}} \underbrace{[1 + \theta(1 - R_{t+h|t,t-J})]^{-1}}_{\text{Smooth DE effect}}
\end{aligned}$$

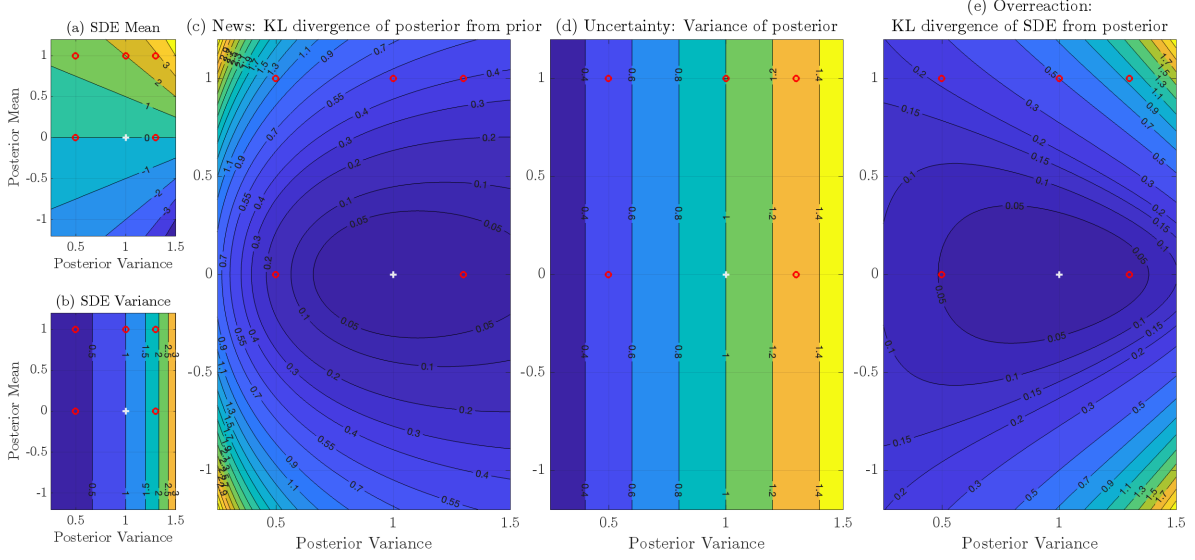
This representation indicates how the revision in conditional moments under Smooth DE can be decomposed as having three parts: (1) the RE revision, (2) an overreaction effect from representativeness as assumed in the standard BGS implementation of DE, and (3) a separate and novel effect stemming from Smooth DE.

## D News and uncertainty effects for the Normal density

In Figure 6, we study how news and uncertainty effects determine the overreaction of the Smooth DE density relative to the true current distribution. To facilitate comparison with Figure 3, we mark the coordinates corresponding to the reference mean and variance with white pluses, and the coordinates corresponding to the current means and variances of each scenario in Figure 3 with red circles. Panels (a) and (b) visually illustrate how the Smooth DE mean and variance change as the posterior mean and variance change and confirm our results in Corollary 1: Panel (a) shows larger overreactions for higher current variances and Panel (b) highlights overconfidence for current variances lower than the reference variance and underconfidence for current variances higher than the reference variance. Panel (c) shows the news effect, measured in terms of the KL divergence of the current distribution from the reference distribution. Interestingly, the KL divergence is large when the current variance is low and there is a large shift in the mean. The news effect is large in that case because we are moving probability masses of tail events under the reference distribution. In contrast, the uncertainty effect is large when the current variance is high (Panel (d)). Panel (e) shows that the uncertainty effect of higher current variance dominates the news effect, so the overreaction of the Smooth DE density (measured in terms of the KL divergence of the Smooth DE density to current density) is largest when there is a large shift in the mean and an increase in variance.



Figure 6: News and uncertainty in a Normal distribution



*Notes:* The figure displays how, as we vary the posterior mean and variance, the following objects change: (a) the Smooth DE mean, (b) the Smooth DE variance, (c) the news component, measured using the KL divergence of the posterior distribution from the prior distribution, (d) the uncertainty component, measured using the posterior variance, and (e) the overall overreaction, measured using the KL divergence of the Smooth DE distribution from the posterior distribution. We mark the coordinates corresponding to the prior mean and variance with white pluses, and the coordinates corresponding to the posterior means and variances of each scenario in Figure 3 with red circles.

## E Data appendix

In what follows, we describe in detail the data and empirical strategy used in Section 4.

**Data cleaning procedure.** We follow Bordalo et al. (2020) and Gemmi and Valchev (2023) and remove outliers by dropping forecasts that are 5 interquartile ranges away from the median forecast for each quarter. We also drop forecasters who have less than 10 observations. We perform the cleaning procedure before computing forecast errors, revisions, and cross-sectional standard deviations.

**Identification of high uncertainty episodes.** To identify high uncertainty episodes, we first compute the cross-sectional standard deviation of individual SPF forecasts for each quarter. For instance, for real GDP, we calculate the time series of the cross-sectional standard deviation of real GDP forecasts. We apply the Hodrick-Prescott (HP) filter ( $\lambda = 1600$ ) to the computed time series to remove low-frequency movements. We then identify periods when the HP-filtered cross-sectional dispersion was significantly above the HP-filter mean as periods of high uncertainty for that variable ( $\sigma_t = \sigma^H$ ). This strategy to identify high uncertainty periods is motivated by Bloom (2009). We follow Bloom (2009) and employ

the threshold of 1.65 standard deviations above the mean, corresponding to the 5% one-sided significance level.

**Variable Definitions.** All survey variables are collected from the Survey of Professional Forecasters. We follow Bordalo et al. (2020) exactly in defining the variables and thus defer to their Online Appendix B for further details.

## F Additional empirical results

We report additional empirical results for Section 4. Table 5 reports results where we use Jurado et al. (2015) 3-months-ahead macroeconomic uncertainty index. As in the baseline regressions, we remove low-frequency movements and identify periods when the Jurado et al. (2015) index is 1.65 standard deviations above the mean. Table 6 reports results where we remove outliers by dropping forecasts that are 4 interquartile ranges away from the median forecast, as advocated in Angeletos et al. (2021).

## G The signal extraction model in Section 4

We provide details of the signal extraction model we introduced in Section 4. Before we discuss the solutions of the model, we first extend our Smooth DE framework to a Kalman filtering problem.

Let us start with some more general notation, which connects to the one used in Definition 1. Consider the same probability space  $(\Omega, \mathcal{F}, (\mathcal{F}_t)_{t \geq 0}, P)$  introduced in Section 3.1. But now allow for noisy information. In particular, let the information available up to time  $t$  be represented by another filtration  $(\mathcal{G}_t)_{t \geq 0}$ , generated by an observed process  $s_t$ . Then let  $f(x_{t+h}|\mathcal{G}_t)$  be the conditional density function of  $X_{t+h}$  based on the information available in  $\mathcal{G}_t$  from the imperfect observations.

Like in Definitions 1 and 2, the representativeness of an event would then become

$$rep(\hat{x}_{t+h}|\mathcal{G}_t, \mathcal{G}_{t-J}) \equiv \frac{f(\hat{x}_{t+h}|\mathcal{G}_t)}{f(\hat{x}_{t+h}|\mathcal{G}_{t-J})} \quad (36)$$

while the conditional density distorted by representativeness is

$$f^\theta(\hat{x}_{t+h}|\mathcal{G}_t, \mathcal{G}_{t-J}) = f(\hat{x}_{t+h}|\mathcal{G}_t) [rep(\hat{x}_{t+h}|\mathcal{G}_t, \mathcal{G}_{t-J})]^\theta Z^{-1} \quad (37)$$

where  $Z$  is a constant of integration and the parameter  $\theta \geq 0$ .

**Smooth Diagnostic Kalman filter.** To derive closed form solutions, we focus on a

Table 5: Forecast error on forecast revision regression coefficients: Jurado et al. (2015)  
3-months-ahead macroeconomic uncertainty

	(1)	(2)	(3)	(4)
	$\beta_C$	$\beta_I$	$\gamma_I$	$\delta_I$
Nominal GDP (NGDP)	0.25 (0.38)	-0.25** (0.11)	-0.13 (0.10)	-0.31 (0.19)
Real GDP (RGDP)	0.11 (0.33)	-0.25* (0.14)	-0.06 (0.10)	-0.47** (0.21)
GDP price index (PGDP)	1.52*** (0.44)	0.09 (0.14)	0.14 (0.15)	-0.56** (0.24)
CPI (CPI)	0.16 (0.23)	-0.47*** (0.18)	-0.46** (0.18)	-0.47** (0.20)
Real consumption (RCONSUM)	-0.29 (0.29)	-0.51*** (0.18)	-0.28** (0.11)	-0.38* (0.22)
Real nonresidential investment (RNRESIN)	0.36 (0.47)	-0.22 (0.23)	-0.02 (0.12)	-0.49 (0.39)
Real residential investment (RRESIN)	0.63 (0.46)	-0.20 (0.15)	-0.11 (0.11)	-0.43 (0.44)
Real federal government consumption (RGF)	-0.39* (0.22)	-0.52*** (0.06)	-0.51*** (0.06)	-0.12 (0.18)
Real state and local government consumption (RGS�)	0.15 (0.31)	-0.47*** (0.06)	-0.44*** (0.06)	-0.16 (0.11)
Industrial production (INDPROD)	0.55* (0.32)	-0.16 (0.10)	-0.06 (0.09)	-0.35 (0.21)
Housing start (HOUSING)	0.19 (0.33)	-0.29*** (0.10)	-0.28*** (0.09)	-0.07 (0.29)
Unemployment rate (UNEMP)	-0.08 (0.33)	-0.29 (0.21)	0.15 (0.10)	-0.59** (0.24)
Three-month Treasury rate (TB3M)	0.78*** (0.23)	0.35*** (0.13)	0.39*** (0.15)	-0.30* (0.18)
Ten-year Treasury rate (TN10Y)	0.14 (0.16)	-0.14* (0.08)	-0.07 (0.09)	-0.57*** (0.12)
AAA corporate bond rate (AAA)	-0.03 (0.22)	-0.25*** (0.07)	-0.23*** (0.08)	-0.35*** (0.13)

Notes: See notes for Table 1.

Table 6: Forecast error on forecast revision regression coefficients: Angeletos et al. (2021)  
data cleaning procedure

	(1)	(2)	(3)	(4)
	$\beta_C$	$\beta_I$	$\gamma_I$	$\delta_I$
Nominal GDP (NGDP)	0.24 (0.38)	-0.24* (0.13)	-0.08 (0.11)	-0.43** (0.18)
Real GDP (RGDP)	0.11 (0.34)	-0.26* (0.15)	-0.11 (0.11)	-0.38* (0.21)
GDP price index (PGDP)	1.47*** (0.43)	0.13 (0.16)	0.17 (0.17)	-0.31 (0.28)
CPI (CPI)	-0.01 (0.27)	-0.54*** (0.19)	-0.54*** (0.19)	-0.54 (0.67)
Real consumption (RCONSUM)	-0.18 (0.31)	-0.42** (0.16)	-0.24 (0.16)	-0.28 (0.26)
Real nonresidential investment (RNRESIN)	0.36 (0.48)	-0.21 (0.23)	0.05 (0.13)	-0.61* (0.34)
Real residential investment (RRESIN)	0.63 (0.46)	-0.20 (0.15)	-0.05 (0.11)	-1.05*** (0.29)
Real federal government consumption (RGF)	-0.40* (0.22)	-0.50*** (0.06)	-0.46*** (0.06)	-0.18 (0.13)
Real state and local government consumption (RGS�)	0.24 (0.35)	-0.43*** (0.05)	-0.36*** (0.06)	-0.23* (0.12)
Industrial production (INDPROD)	0.52 (0.33)	-0.16 (0.11)	-0.05 (0.11)	-0.47*** (0.18)
Housing start (HOUSING)	0.21 (0.32)	-0.28*** (0.10)	-0.20* (0.11)	-0.40* (0.22)
Unemployment rate (UNEMP)	-0.09 (0.32)	-0.30 (0.22)	0.27** (0.13)	-0.91*** (0.17)
Three-month Treasury rate (TB3M)	0.75*** (0.23)	0.36*** (0.13)	0.29*** (0.11)	1.36*** (0.45)
Ten-year Treasury rate (TN10Y)	0.14 (0.16)	-0.13 (0.08)	-0.10 (0.09)	-0.73*** (0.17)
AAA corporate bond rate (AAA)	-0.04 (0.22)	-0.25*** (0.08)	-0.25*** (0.08)	-0.25 (0.26)

Notes: See notes for Table 1.

standard Gaussian case of noisy information and maintain  $J = 1$ . In particular, consider a standard state-space representation. The observation equation is:

$$s_t = x_t + \varepsilon_t, \quad \varepsilon_t \sim N(0, \sigma_\varepsilon^2)$$

and the state transition equation for the unobserved  $x_t$  is

$$x_t = \rho x_{t-1} + u_t, \quad u_t \sim N(0, \sigma_u^2)$$

The Kalman Filter gives the Bayesian forecast, and its derivation is standard. The one-step-ahead prediction from the period  $t-1$  estimate  $x_{t-1|t-1}$  and its associated error variance  $\Sigma_{t-1|t-1}$  are given by

$$x_{t|t-1} = \rho x_{t-1|t-1}; \Sigma_{t|t-1} = \rho^2 \Sigma_{t-1|t-1} + \sigma_u^2.$$

Then, the estimates are updated according to

$$x_{t|t} = x_{t|t-1} + K_t(s_t - x_{t|t-1}), \quad K_t = \frac{\Sigma_{t|t-1}}{\Sigma_{t|t-1} + \sigma_\varepsilon^2},$$

where  $K_t$  is the Kalman gain and the updating rule for the variance is

$$\Sigma_{t|t} = \left[ \frac{\sigma_\varepsilon^2}{\Sigma_{t|t-1} + \sigma_\varepsilon^2} \right] \Sigma_{t|t-1}. \quad (38)$$

In this environment, we now derive the version of Kalman filter used by agents subject to Smooth DE. This connects and extends the diagnostic Kalman Filter derived within the standard BGS formulation in earlier work like Bordalo et al. (2019) and Bordalo et al. (2020).

Let  $f(x_t|\mathcal{G}_t)$  be the probability density of the rational, or Bayesian, period  $t$  estimate of the current underlying state  $x_t$  based on the Kalman Filter derived above. Intuitively, by equation (36), a state  $x_t$  is more representative if it becomes more likely relative to the  $t-1$  forecast. As in our discussion of equation (9), the key feature with respect to the original BGS formulation is to condition on the whole past information set, and as a result, to take into account the associated *uncertainty*.

Let the ratio of current to prior estimation uncertainty under RE be denoted as

$$R_{t|t,t-1} \equiv \Sigma_{t|t} / \Sigma_{t|t-1}.$$

We derive the following result.

**Proposition 9** (*Smooth DE Kalman Filter.*) The density  $f^\theta(\hat{x}_t|\mathcal{G}_t, \mathcal{G}_{t-1})$  in equation (37) has a Normal distribution with mean

$$\mathbb{E}_t^\theta(x_t) = x_{t|t-1} + \left(1 + \frac{R_{t|t,t-1}\theta}{1 + (1 - R_{t|t,t-1})\theta}\right) K_t(s_t - x_{t|t-1}), \quad (39)$$

and variance

$$\mathbb{V}_t^\theta(x_t) = \frac{\Sigma_{t|t}}{1 + (1 - R_{t|t,t-1})\theta} \quad (40)$$

**Proof.** Re-writing the expression (37):

$$f_t^\theta(x_t) \propto \exp\left[-\frac{1}{2\Sigma_{t|t}}(x_t - x_{t|t})^2\right] \left[\frac{\exp\left[-\frac{1}{2\Sigma_{t|t}}(x_t - x_{t|t})^2\right]}{\exp\left[-\frac{1}{2\Sigma_{t|t-1}}(x_t - x_{t|t-1})^2\right]}\right]^\theta \frac{1}{Z}$$

Collecting the terms in the exponents, we get:

$$f_t^\theta(x_t) \propto \exp\left[-\frac{1}{2\Sigma_{t|t}}\left[(1 + \theta)(x_t - x_{t|t})^2 - \frac{\Sigma_{t|t}}{\Sigma_{t|t-1}}\theta(x_t - x_{t|t-1})^2\right]\right] \frac{1}{Z}$$

Developing the squared terms and keeping track of the terms involving  $x_t$ , we obtain:

$$f_t^\theta(x_t) \propto \exp\left[\begin{aligned} &-\frac{1}{2\Sigma_{t|t}}\left(1 + \theta - \frac{\Sigma_{t|t}}{\Sigma_{t|t-1}}\theta\right) \\ &\left[x_t^2 - 2x_t\left(1 + \theta - \frac{\Sigma_{t|t}}{\Sigma_{t|t-1}}\theta\right)^{-1}\left((1 + \theta)\tilde{x}_{t|t} - \frac{\Sigma_{t|t}}{\Sigma_{t|t-1}}\theta x_{t|t-1}\right)\right] \end{aligned}\right] \frac{1}{Z}$$

where the remaining terms are absorbed in the constant of integration. The one above is the kernel of a normal with mean:

$$\begin{aligned} \mathbb{E}_t^\theta(x_t) &= \left(1 + \theta - \frac{\Sigma_{t|t}}{\Sigma_{t|t-1}}\theta\right)^{-1} \left((1 + \theta)x_{t|t} - \frac{\Sigma_{t|t}}{\Sigma_{t|t-1}}\theta x_{t|t-1}\right) \\ &= x_{t|t} + \frac{R_{t|t,t-1}\theta}{1 + (1 - R_{t|t,t-1})\theta} (x_{t|t} - x_{t|t-1}) \\ &= x_{t|t-1} + \left(1 + \frac{R_{t|t,t-1}\theta}{1 + (1 - R_{t|t,t-1})\theta}\right) (x_{t|t} - x_{t|t-1}) \\ &= x_{t|t-1} + \left(1 + \frac{R_{t|t,t-1}\theta}{1 + (1 - R_{t|t,t-1})\theta}\right) K_t(s_t - x_{t|t-1}), \end{aligned}$$

where  $R_{t|t,t-1} \equiv \Sigma_{t|t}/\Sigma_{t|t-1}$  and in the fourth line we used (G), and variance:

$$\begin{aligned}\mathbb{V}_t^\theta(x_t) &= \Sigma_{t|t} \left( 1 + \theta - \frac{\Sigma_{t|t}}{\Sigma_{t|t-1}} \theta \right)^{-1} \\ &= \frac{\Sigma_{t|t}}{1 + (1 - R_{t|t,t-1}) \theta}.\end{aligned}$$

This gives us the result stated in Proposition 9. ■

Like in our earlier general discussion, we observe overreaction of the conditional mean when  $\theta > 0$  and the new information does not fully resolve uncertainty, i.e. when  $\sigma_\varepsilon^2 > 0$ . Furthermore, similarly to the earlier AR(1) example, this environment is also characterized by a conditional reduction in uncertainty, and therefore by overconfidence. Indeed, as long as  $\sigma_\varepsilon^2$  is finite, by equation (38) estimation uncertainty decreases over time, as the new signal is at least partly informative. It follows that the ratio  $R_{t|t,t-1} < 1, \forall t$  and that given equation (40), subjective uncertainty is lower than Bayesian estimation uncertainty, i.e.  $\mathbb{V}_t^\theta(x_t) < \Sigma_{t|t}$ .

**The forecasting problem.** We now return to the model in Section 4. Agents form forecasts about  $y_{t+h}$  which the sum of hidden  $x_{t+h}$  and a random shock. Assuming the Kalman filter is at the steady state, the Smooth DE forecast by forecaster  $i$  is given by

$$\begin{aligned}y_{i,t+h|t}^\theta &= \rho^h \left[ x_{i,t|t-1} + \left( 1 + \tilde{\theta}_{t|t-1} \right) K (s_{i,t} - x_{i,t|t-1}) \right], \\ \tilde{\theta}_{t,t-1} &= \theta \frac{R_{t+h|t,t-1}}{1 + \theta (1 - R_{t+h|t,t-1})}, \\ R_{t+h|t,t-1} &= \frac{\mathbb{V}_t(y_{t+h})}{\mathbb{V}_{t-1}(y_{t+h})} \\ &= \frac{\Sigma_{t+h|t} + \sigma_{\eta,t}^2}{\Sigma_{t+h|t-1} + \sigma_{\eta,t-1}^2} \\ &= \frac{\rho^{2h}\Sigma + \sum_{l=0}^{h-1} \rho^{2l}\sigma_u^2 + \sigma_{\eta,t}^2}{\rho^{2(h+1)}\Sigma + \sum_{l=0}^h \rho^{2l}\sigma_u^2 + \sigma_{\eta,t-1}^2},\end{aligned}$$

where  $K = \frac{\Sigma}{\Sigma + \sigma_\varepsilon^2}$  is the steady-state Kalman gain and the steady-state posterior variance  $\Sigma = \Sigma_{t|t-1}$  is given by

$$\Sigma = \frac{\sigma_u^2 - (1 - \rho^2) \sigma_\varepsilon^2 + \sqrt{[\sigma_u^2 - (1 - \rho^2) \sigma_\varepsilon^2]^2 + 4\sigma_\varepsilon^2 \sigma_u^2}}{2},$$

and we made the anticipated utility assumption as described in footnote 14 to compute

$$\frac{\mathbb{V}_t(y_{t+h})}{\mathbb{V}_{t-1}(y_{t+h})}.$$

There are four possible values for  $\tilde{\theta}_{t,t-1}$ :

$$1. \sigma_{\eta,t-1} = \sigma_{\eta}^L, \sigma_{\eta,t} = \sigma_{\eta}^H:$$

$$\begin{aligned}\tilde{\theta}_{t,t-1}(\sigma_{\eta,t-1} = \sigma_{\eta}^L, \sigma_{\eta,t} = \sigma_{\eta}^H) &= \theta \frac{R_{t+h|t,t-1}}{1 + \theta(1 - R_{t+h|t,t-1})} \\ R_{t+h|t,t-1} &= \frac{\rho^{2h}\Sigma + \sum_{l=0}^{h-1} \rho^{2l}\sigma_u^2 + (\sigma_{\eta}^H)^2}{\rho^{2(h+1)}\Sigma + \sum_{l=0}^h \rho^{2l}\sigma_u^2 + (\sigma_{\eta}^L)^2}\end{aligned}$$

$$2. \sigma_{\eta,t-1} = \sigma_{\eta}^H, \sigma_{\eta,t} = \sigma_{\eta}^H:$$

$$\begin{aligned}\tilde{\theta}_{t,t-1}(\sigma_{\eta,t-1} = \sigma_{\eta}^H, \sigma_{\eta,t} = \sigma_{\eta}^H) &= \theta \frac{R_{t+h|t,t-1}}{1 + \theta(1 - R_{t+h|t,t-1})} \\ R_{t+h|t,t-1} &= \frac{\rho^{2h}\Sigma + \sum_{l=0}^{h-1} \rho^{2l}\sigma_u^2 + (\sigma_{\eta}^H)^2}{\rho^{2(h+1)}\Sigma + \sum_{l=0}^h \rho^{2l}\sigma_u^2 + (\sigma_{\eta}^H)^2}\end{aligned}$$

$$3. \sigma_{\eta,t-1} = \sigma_{\eta}^L, \sigma_{\eta,t} = \sigma_{\eta}^L:$$

$$\begin{aligned}\tilde{\theta}_{t,t-1}(\sigma_{\eta,t-1} = \sigma_{\eta}^L, \sigma_{\eta,t} = \sigma_{\eta}^L) &= \theta \frac{R_{t+h|t,t-1}}{1 + \theta(1 - R_{t+h|t,t-1})} \\ R_{t+h|t,t-1} &= \frac{\rho^{2h}\Sigma + \sum_{l=0}^{h-1} \rho^{2l}\sigma_u^2 + (\sigma_{\eta}^L)^2}{\rho^{2(h+1)}\Sigma + \sum_{l=0}^h \rho^{2l}\sigma_u^2 + (\sigma_{\eta}^L)^2}\end{aligned}$$

$$4. \sigma_{\eta,t-1} = \sigma_{\eta}^H, \sigma_{\eta,t} = \sigma_{\eta}^L:$$

$$\begin{aligned}\tilde{\theta}_{t,t-1}(\sigma_{\eta,t-1} = \sigma_{\eta}^H, \sigma_{\eta,t} = \sigma_{\eta}^L) &= \theta \frac{R_{t+h|t,t-1}}{1 + \theta(1 - R_{t+h|t,t-1})} \\ R_{t+h|t,t-1} &= \frac{\rho^{2h}\Sigma + \sum_{l=0}^{h-1} \rho^{2l}\sigma_u^2 + (\sigma_{\eta}^L)^2}{\rho^{2(h+1)}\Sigma + \sum_{l=0}^h \rho^{2l}\sigma_u^2 + (\sigma_{\eta}^H)^2}\end{aligned}$$

So we have

$$\begin{aligned}\tilde{\theta}_{t,t-1}(\sigma_{\eta,t-1} = \sigma_{\eta}^H, \sigma_{\eta,t} = \sigma_{\eta}^L) &< \tilde{\theta}_{t,t-1}(\sigma_{\eta,t-1} = \sigma_{\eta}^L, \sigma_{\eta,t} = \sigma_{\eta}^L) \\ &< \tilde{\theta}_{t,t-1}(\sigma_{\eta,t-1} = \sigma_{\eta}^H, \sigma_{\eta,t} = \sigma_{\eta}^H) < \tilde{\theta}_{t,t-1}(\sigma_{\eta,t-1} = \sigma_{\eta}^L, \sigma_{\eta,t} = \sigma_{\eta}^H).\end{aligned}$$

Thus, forecasters overreact more when uncertainty is high ( $\sigma_{\eta,t} = \sigma_{\eta}^H$ ).

**Cross-sectional dispersions.** First, we derive the RE consensus forecast and the cross-



sectional variance of forecasts. The consensus forecast is given by

$$\begin{aligned}
y_{t+h|t} = x_{t+h|t} &= \int_0^1 x_{i,t+h|t} di \\
&= \rho^h \int_0^1 [x_{i,t|t-1} + K(s_{i,t} - x_{i,t|t-1})] di \\
&= \rho^h [x_{t|t-1} + K(x_t - x_{t|t-1})]
\end{aligned}$$

and the cross-sectional variance of individual forecasts is given by

$$\begin{aligned}
\sigma(x_{i,t+h|t})^2 &= \int_0^1 (\rho^h x_{i,t|t} - \rho^h x_{t|t})^2 di \\
&= \int_0^1 [\rho^h [x_{i,t|t-1} + K(s_{i,t} - x_{i,t|t-1})] - \rho^h [x_{t|t-1} + K(x_t - x_{t|t-1})]]^2 di \\
&= \int_0^1 [\rho^h(1-K)(x_{i,t|t-1} - x_{t|t-1}) + \rho^h K(s_{i,t} - x_t)]^2 di \\
&= \int_0^1 [\rho(1-K)(x_{i,t+h-1|t-1} - x_{t+h-1|t-1}) + \rho^h K \varepsilon_{i,t}]^2 di \\
&= \rho^2(1-K)^2 \sigma(x_{i,t+h-1|t-1})^2 + \rho^{2h} K^2 \sigma_\varepsilon^2
\end{aligned}$$

The cross-sectional variance is constant under RE:  $\sigma(x_{i,h})^2 = \sigma(x_{i,t+h|t})^2 = \sigma(x_{i,t+h-1|t-1})^2$  so that

$$\begin{aligned}
\sigma(x_{i,h})^2 &= \rho^2(1-K)^2 \sigma(x_{i,h})^2 + \rho^{2h} K^2 \sigma_\varepsilon^2 \\
\sigma(x_{i,h})^2 &= \frac{\rho^{2h} K^2 \sigma_\varepsilon^2}{1 - \rho^2(1-K)^2}.
\end{aligned}$$

Next, we derive the Smooth DE consensus forecast and the cross-sectional variance of forecasts. The consensus forecast is given by

$$\begin{aligned}
y_{t+h|t}^\theta &= \int_0^1 y_{i,t+h|t}^\theta di \\
&= \rho^h [x_{t|t} + \tilde{\theta}_{t,t-1} (x_{t|t} - x_{t|t-1})]
\end{aligned}$$

and the cross-sectional variance of individual forecasts is given by

$$\begin{aligned}
\sigma(y_{i,t+h|t}^\theta)^2 &= \int_0^1 \left[ x_{i,t+h|t} + \tilde{\theta}_{t,t-1} (x_{i,t+h|t} - x_{i,t+h|t-1}) - \left[ x_{t+h|t} + \tilde{\theta}_{t,t-1} (x_{t+h|t} - x_{t+h|t-1}) \right] \right]^2 di \\
&= \int_0^1 \left[ \left(1 + \tilde{\theta}_{t,t-1}\right) (x_{i,t+h|t} - x_{t+h|t}) - \tilde{\theta}_{t,t-1} (x_{i,t+h|t-1} - x_{t+h|t-1}) \right]^2 di \\
&= \left[ \left(1 + \tilde{\theta}_{t,t-1}\right)^2 + \tilde{\theta}_{t,t-1}^2 \right] \sigma(x_{i,h})^2 - 2 \left(1 + \tilde{\theta}_{t,t-1}\right) \tilde{\theta}_{t,t-1} \text{cov}(x_{i,t+h|t} - x_{t+h|t}, x_{i,t+h|t-1} - x_{t+h|t-1})
\end{aligned}$$

where

$$\sigma(x_{i,h})^2 = \frac{\rho^{2h} K^2 \sigma_\varepsilon^2}{1 - \rho^2(1 - K)^2}.$$

We have

$$\begin{aligned}
\text{cov}(x_{i,t+h|t} - x_{t+h|t}, x_{i,t+h|t-1} - x_{t+h|t-1}) &= \text{cov}(\rho^h(x_{i,t|t} - x_{t|t}), \rho^{h+1}(x_{i,t-1|t-1} - x_{t-1|t-1})) \\
&= \rho^{2(h+1)}(1 - K)\sigma(x_{i,h})^2,
\end{aligned}$$

where we used

$$\begin{aligned}
x_{i,t|t} - x_{t|t} &= [x_{i,t|t-1} + K(s_{i,t} - x_{i,t|t-1})] - [x_{t|t-1} + K(x_t - x_{t|t-1})] \\
&= (1 - K)(x_{i,t|t-1} - x_{t|t-1}) + K(s_{i,t} - x_t) \\
&= \rho(1 - K)(x_{i,t-1|t-1} - x_{t-1|t-1}) + K\varepsilon_{i,t}.
\end{aligned}$$

Thus we get

$$\begin{aligned}
\sigma(y_{i,t+h|t}^\theta)^2 &= \left[ \left(1 + \tilde{\theta}_{t,t-1}\right)^2 + \tilde{\theta}_{t,t-1}^2 \right] \sigma(x_{i,h})^2 - 2 \left(1 + \tilde{\theta}_{t,t-1}\right) \tilde{\theta}_{t,t-1} \rho^{2(h+1)}(1 - K)\sigma(x_{i,h})^2 \\
&= \left[ 1 + 2 \left(1 + \tilde{\theta}_{t,t-1}\right) \tilde{\theta}_{t,t-1} (1 - \rho^{2(h+1)}(1 - K)) \right] \sigma(x_{i,h})^2.
\end{aligned}$$

So the cross-sectional variance of  $h$ -period-ahead forecast  $\sigma(y_{i,t+h|t}^\theta)^2$  is increasing in  $\tilde{\theta}_{t,t-1}$ , which in turn is increasing in uncertainty  $\sigma_{\eta,t}$ . For the standard DE, we have

$$\sigma(y_{i,t+h|t}^\theta)^2 = [1 + 2(1 + \theta)\theta(1 - \rho^{2(h+1)}(1 - K))] \sigma(x_{i,h})^2,$$

so the cross-sectional variance is constant.

**Consensus regression.** We have

$$\beta_C = \frac{\text{cov}\left(y_{t+h} - y_{t+h|t}^\theta, y_{t+h|t}^\theta - y_{t+h|t-1}^\theta\right)}{\text{var}\left(y_{t+h|t}^\theta - y_{t+h|t-1}^\theta\right)},$$

where

$$\begin{aligned} x_t - x_{t|t} &= x_t - [x_{t|t-1} + K(x_t - x_{t|t-1})] \\ x_t - x_{t|t} &= \frac{1-K}{K}(x_{t|t} - x_{t|t-1}) \\ x_t - x_{t|t}^\theta &= x_t - [x_{t|t} + \tilde{\theta}_{t,t-1}(x_{t|t} - x_{t|t-1})] \\ &= \left[\frac{1-K}{K} - \tilde{\theta}_{t,t-1}\right](x_{t|t} - x_{t|t-1}), \end{aligned}$$

so the forecast error can be expressed as

$$\begin{aligned} y_{t+h} - y_{t+h|t}^\theta &= x_{t+h} + \eta_{t+h} - x_{t+h|t}^\theta \\ &= \rho^h x_t + \sum_{l=1}^h \rho^{h-l} u_{t+l} + \eta_{t+h} - \rho^h x_{t|t}^\theta \\ &= \rho^h \left[\frac{1-K}{K} - \tilde{\theta}_{t,t-1}\right](x_{t|t} - x_{t|t-1}) + \sum_{l=1}^h \rho^{h-l} u_{t+l} + \eta_{t+h}. \end{aligned}$$

To derive the forecast revision, note

$$\begin{aligned} x_{t|t}^\theta - x_{t|t-1}^\theta &= [x_{t|t} + \tilde{\theta}_{t,t-1}(x_{t|t} - x_{t|t-1})] - [x_{t|t-1} + \tilde{\theta}_{t-1,t-2}(x_{t|t-1} - x_{t|t-2})] \\ &= (1 + \tilde{\theta}_{t,t-1})(x_{t|t} - x_{t|t-1}) - \tilde{\theta}_{t-1,t-2}\rho(x_{t-1|t-1} - x_{t-1|t-2}) \end{aligned}$$

and the forecast revision can be expressed as

$$y_{t+h|t}^\theta - y_{t+h|t-1}^\theta = \rho^h \left[ (1 + \tilde{\theta}_{t,t-1})(x_{t|t} - x_{t|t-1}) - \tilde{\theta}_{t-1,t-2}\rho(x_{t-1|t-1} - x_{t-1|t-2}) \right].$$

We have

$$\begin{aligned}
& cov_t (y_{t+h} - y_{t+h|t}^\theta, y_{t+h|t}^\theta - y_{t+h|t-1}^\theta) \\
&= \rho^{2h} cov \left( \left[ \frac{1-K}{K} - \tilde{\theta}_{t,t-1} \right] (x_{t|t} - x_{t|t-1}), \left( 1 + \tilde{\theta}_{t,t-1} \right) (x_{t|t} - x_{t|t-1}) - \tilde{\theta}_{t-1,t-2} \rho (x_{t-1|t-1} - x_{t-1|t-2}) \right) \\
&= \rho^{2h} \left[ \frac{1-K}{K} - \tilde{\theta}_{t,t-1} \right] \left[ \left( 1 + \tilde{\theta}_{t,t-1} \right) var (x_{t|t} - x_{t|t-1}) - \tilde{\theta}_{t-1,t-2} \rho cov (x_{t|t} - x_{t|t-1}, x_{t-1|t-1} - x_{t-1|t-2}) \right].
\end{aligned}$$

To compute  $cov (x_{t|t} - x_{t|t-1}, x_{t-1|t-1} - x_{t-1|t-2})$ , note

$$\begin{aligned}
x_{t|t} &= x_{t|t-1} + K (x_t - x_{t|t-1}) \\
&= (1-K)\rho x_{t-1|t-1} + Kx_t \\
x_{t|t-1} &= (1-K)\rho x_{t-1|t-2} + K\rho x_{t-1} \\
x_{t|t} - x_{t|t-1} &= (1-K)\rho (x_{t-1|t-1} - x_{t-1|t-2}) + Ku_t
\end{aligned}$$

so

$$\begin{aligned}
cov (x_{t|t} - x_{t|t-1}, x_{t-1|t-1} - x_{t-1|t-2}) &= (1-K)\rho var (x_{t-1|t-1} - x_{t-1|t-2}) \\
&= (1-K)\rho var (x_{t|t} - x_{t|t-1}).
\end{aligned}$$

Thus

$$\begin{aligned}
& cov_t (y_{t+h} - y_{t+h|t}^\theta, y_{t+h|t}^\theta - y_{t+h|t-1}^\theta) \\
&= \rho^{2h} \left[ \frac{1-K}{K} - \tilde{\theta}_{t,t-1} \right] \left[ \left( 1 + \tilde{\theta}_{t,t-1} \right) - (1-K)\tilde{\theta}_{t-1,t-2}\rho^2 \right] var (x_{t|t} - x_{t|t-1}),
\end{aligned}$$

and also

$$\begin{aligned}
& var (y_{t+h|t}^\theta - y_{t+h|t-1}^\theta) \\
&= \rho^{2h} var \left( \left( 1 + \tilde{\theta}_{t,t-1} \right) (x_{t|t} - x_{t|t-1}) - \tilde{\theta}_{t-1,t-2} \rho (x_{t-1|t-1} - x_{t-1|t-2}) \right) \\
&= \rho^{2h} \left[ \left[ \left( 1 + \tilde{\theta}_{t,t-1} \right) - \left( \tilde{\theta}_{t-1,t-2} \rho \right) \right]^2 + 2 \left( 1 + \tilde{\theta}_{t,t-1} \right) \tilde{\theta}_{t-1,t-2} \rho [1 - (1-K)\rho] \right] var (x_{t|t} - x_{t|t-1}).
\end{aligned}$$

So we have

$$\frac{\text{cov}_t \left( y_{t+h} - y_{t+h|t}^\theta, y_{t+h|t}^\theta - y_{t+h|t-1}^\theta \right)}{\text{var}_t \left( y_{t+h|t}^\theta - y_{t+h|t-1}^\theta \right)} = \left[ \frac{1-K}{K} - \tilde{\theta}_{t,t-1} \right] \frac{\left( 1 + \tilde{\theta}_{t,t-1} \right) - \tilde{\theta}_{t-1,t-2}(1-K)\rho^2}{\left[ \left( 1 + \tilde{\theta}_{t,t-1} \right) - \left( \tilde{\theta}_{t-1,t-2}\rho \right) \right]^2 + 2 \left( 1 + \tilde{\theta}_{t,t-1} \right) \tilde{\theta}_{t-1,t-2}\rho [1 - (1-K)\rho]}.$$

We assume that the volatility evolves according to an exogenous first-order Markov process. Then we have the unconditional covariance and variance expressed as

$$\begin{aligned} & \text{cov} \left( y_{t+h} - y_{t+h|t}^\theta, y_{t+h|t}^\theta - y_{t+h|t-1}^\theta \right) \\ &= \sum_{j,k,l} \left[ \Pr(\sigma_{\eta,t-2} = \sigma_\eta^j, \sigma_{\eta,t-1} = \sigma_\eta^k, \sigma_{\eta,t} = \sigma_\eta^l) \text{cov}_t \left( y_{t+h} - y_{t+h|t}^\theta, y_{t+h|t}^\theta - y_{t+h|t-1}^\theta; \sigma_{\eta,t-2} = \sigma_\eta^j, \sigma_{\eta,t-1} = \sigma_\eta^k, \sigma_{\eta,t} = \sigma_\eta^l \right) \right], \\ & \text{var} \left( y_{t+h|t}^\theta - y_{t+h|t-1}^\theta \right) \\ &= \sum_{j,k,l} \left[ \Pr(\sigma_{\eta,t-2} = \sigma_\eta^j, \sigma_{\eta,t-1} = \sigma_\eta^k, \sigma_{\eta,t} = \sigma_\eta^l) \text{var}_t \left( y_{t+h|t}^\theta - y_{t+h|t-1}^\theta; \sigma_{\eta,t-2} = \sigma_\eta^j, \sigma_{\eta,t-1} = \sigma_\eta^k, \sigma_{\eta,t} = \sigma_\eta^l \right) \right], \\ & \Pr(\sigma_{\eta,t-2} = \sigma_\eta^j, \sigma_{\eta,t-1} = \sigma_\eta^k, \sigma_{\eta,t} = \sigma_\eta^l) \\ &= \Pr(\sigma_\eta = \sigma_\eta^j) \Pr(\sigma_{\eta,t-1} = \sigma_\eta^k | \sigma_{\eta,t-2} = \sigma_\eta^j) \Pr(\sigma_{\eta,t} = \sigma_\eta^l | \sigma_{\eta,t-1} = \sigma_\eta^k) \end{aligned}$$

where  $j, k, l \in \{L, H\}$  and  $\text{cov}_t \left( y_{t+h} - y_{t+h|t}^\theta, y_{t+h|t}^\theta - y_{t+h|t-1}^\theta; \sigma_{\eta,t-2} = \sigma_\eta^j, \sigma_{\eta,t-1} = \sigma_\eta^k, \sigma_{\eta,t} = \sigma_\eta^l \right)$  and  $\text{var}_t \left( y_{t+h|t}^\theta - y_{t+h|t-1}^\theta; \sigma_{\eta,t-2} = \sigma_\eta^j, \sigma_{\eta,t-1} = \sigma_\eta^k, \sigma_{\eta,t} = \sigma_\eta^l \right)$  are the covariance and variance if  $\sigma_{\eta,t-2} = \sigma_\eta^j, \sigma_{\eta,t-1} = \sigma_\eta^k, \sigma_{\eta,t} = \sigma_\eta^l$ .  $\Pr(\sigma_\eta = \sigma_\eta^j)$  is the unconditional probability of  $\sigma_{\eta,t} = \sigma_\eta^j$ . Then we have

$$\beta_C = \sum_{j,k,l} \left[ w_C(\sigma_{\eta,t-2} = \sigma_\eta^j, \sigma_{\eta,t-1} = \sigma_\eta^k, \sigma_{\eta,t} = \sigma_\eta^l) \beta_C(\sigma_{\eta,t-2} = \sigma_\eta^j, \sigma_{\eta,t-1} = \sigma_\eta^k, \sigma_{\eta,t} = \sigma_\eta^l) \right],$$

where

$$\begin{aligned} & w_C(\sigma_{\eta,t-2} = \sigma_\eta^j, \sigma_{\eta,t-1} = \sigma_\eta^k, \sigma_{\eta,t} = \sigma_\eta^l) \\ & \equiv \frac{\Pr(\sigma_{\eta,t-2} = \sigma_\eta^j, \sigma_{\eta,t-1} = \sigma_\eta^k, \sigma_{\eta,t} = \sigma_\eta^l) \text{var}_t \left( y_{t+h|t}^\theta - y_{t+h|t-1}^\theta; \sigma_{\eta,t-2} = \sigma_\eta^j, \sigma_{\eta,t-1} = \sigma_\eta^k, \sigma_{\eta,t} = \sigma_\eta^l \right)}{\text{var} \left( y_{t+h|t}^\theta - y_{t+h|t-1}^\theta \right)}, \\ & \beta_C(\sigma_{\eta,t-2} = \sigma_\eta^j, \sigma_{\eta,t-1} = \sigma_\eta^k, \sigma_{\eta,t} = \sigma_\eta^l) \equiv \frac{\text{cov}_t \left( y_{t+h} - y_{t+h|t}^\theta, y_{t+h|t}^\theta - y_{t+h|t-1}^\theta; \sigma_{\eta,t-2} = \sigma_\eta^j, \sigma_{\eta,t-1} = \sigma_\eta^k, \sigma_{\eta,t} = \sigma_\eta^l \right)}{\text{var}_t \left( y_{t+h|t}^\theta - y_{t+h|t-1}^\theta; \sigma_{\eta,t-2} = \sigma_\eta^j, \sigma_{\eta,t-1} = \sigma_\eta^k, \sigma_{\eta,t} = \sigma_\eta^l \right)}. \end{aligned}$$

The sufficient condition for  $\beta_C > 0$  is

$$\begin{aligned}\tilde{\theta}_{t,t-1}(\sigma_{\eta,t-1} = \sigma_{\eta}^L, \sigma_{\eta,t} = \sigma_{\eta}^H) &< \frac{1-K}{K} = \frac{\sigma_{\varepsilon}^2}{\Sigma}, \\ \tilde{\theta}_{t,t-1}(\sigma_{\eta,t-1} = \sigma_{\eta}^H, \sigma_{\eta,t} = \sigma_{\eta}^L) &> \tilde{\theta}_{t-1,t-2}(\sigma_{\eta,t-2} = \sigma_{\eta}^L, \sigma_{\eta,t-1} = \sigma_{\eta}^H)(1-K)\rho^2.\end{aligned}$$

For the standard DE, we have

$$\beta_C = \left[ \frac{1-K}{K} - \theta \right] \frac{1 + \theta[1 - (1-K)\rho^2]}{[1 + \theta(1-\rho)]^2 + 2(1+\theta)\theta\rho[1 - (1-K)\rho]},$$

so we have  $\beta_C > 0$  if and only if  $\theta < \sigma_{\varepsilon}^2/\Sigma$ .

**Individual-level regression.** We have

$$\beta_I = \frac{\text{cov}\left(y_{t+h} - y_{i,t+h|t}^{\theta}, y_{i,t+h|t}^{\theta} - y_{i,t+h|t-1}^{\theta}\right)}{\text{var}\left(y_{i,t+h|t}^{\theta} - y_{i,t+h|t-1}^{\theta}\right)},$$

where

$$\begin{aligned}y_{t+h} - y_{i,t+h|t}^{\theta} &= x_{t+h} + \eta_{t+h} - x_{i,t+h|t}^{\theta} \\ &= \rho^h \left[ (x_t - x_{i,t|t}) - \tilde{\theta}_{t,t-1} (x_{i,t|t} - x_{i,t|t-1}) \right] + \sum_{l=1}^h \rho^{h-l} u_{t+l} + \eta_{t+h}\end{aligned}$$

$$\begin{aligned}y_{i,t+h|t}^{\theta} - y_{i,t+h|t-1}^{\theta} &= \rho^h [x_{i,t|t}^{\theta} - x_{i,t|t-1}^{\theta}] \\ &= \rho^h \left[ \left(1 + \tilde{\theta}_{t,t-1}\right) (x_{i,t|t} - x_{i,t|t-1}) - \tilde{\theta}_{t-1,t-2} (x_{i,t|t-1} - x_{i,t|t-2}) \right]\end{aligned}$$

The covariance and variance are given by

$$\begin{aligned}
& cov_t \left( y_{t+h} - y_{i,t+h|t}^\theta, y_{i,t+h|t}^\theta - y_{i,t+h|t-1}^\theta \right) \\
&= \left[ \left( 1 + \tilde{\theta}_{t,t-1} \right) cov \left( x_t - x_{i,t|t}, x_{i,t|t} - x_{i,t|t-1} \right) \right. \\
&\quad - \tilde{\theta}_{t-1,t-2} cov \left( x_t - x_{i,t|t}, x_{i,t|t-1} - x_{i,t|t-2} \right) \\
&\quad - \tilde{\theta}_{t,t-1} \left( 1 + \tilde{\theta}_{t,t-1} \right) var \left( x_{i,t|t} - x_{i,t|t-1} \right) \\
&\quad \left. + \tilde{\theta}_{t,t-1} \tilde{\theta}_{t-1,t-2} cov \left( x_{i,t|t} - x_{i,t|t-1}, x_{i,t|t-1} - x_{i,t|t-2} \right) \right] \\
&= \rho^{2h} \left[ -\tilde{\theta}_{t,t-1} \left( 1 + \tilde{\theta}_{t,t-1} \right) var \left( x_{i,t|t} - x_{i,t|t-1} \right) \right], \\
& var_t \left( y_{i,t+h|t}^\theta - y_{i,t+h|t-1}^\theta \right) \\
&= \rho^{2h} var \left( \left( 1 + \tilde{\theta}_{t,t-1} \right) \left( x_{i,t|t} - x_{i,t|t-1} \right) - \tilde{\theta}_{t-1,t-2} \left( x_{i,t|t-1} - x_{i,t|t-2} \right) \right) \\
&= \rho^{2h} \left[ \left( 1 + \tilde{\theta}_{t,t-1} \right)^2 var \left( x_{i,t|t} - x_{i,t|t-1} \right) \right. \\
&\quad + \tilde{\theta}_{t-1,t-2}^2 var \left( \rho x_{i,t-1|t-1} - \rho x_{i,t-1|t-2} \right) \\
&\quad \left. - 2 \left( 1 + \tilde{\theta}_{t,t-1} \right) \tilde{\theta}_{t-1,t-2} cov \left( x_{i,t|t} - x_{i,t|t-1}, x_{i,t|t-1} - \rho x_{i,t|t-2} \right) \right] \\
&= \rho^{2h} \left[ \left( 1 + \tilde{\theta}_{t,t-1} \right)^2 + \left( \tilde{\theta}_{t-1,t-2} \rho \right)^2 \right] var \left( x_{i,t|t} - x_{i,t|t-1} \right)
\end{aligned}$$

where we used  $cov \left( x_t - x_{i,t|t}, x_{i,t|t} - x_{i,t|t-1} \right) = 0$ ,  $cov \left( x_t - x_{i,t|t}, x_{i,t|t-1} - x_{i,t|t-2} \right) = 0$ , and  $cov \left( x_{i,t|t} - x_{i,t|t-1}, x_{i,t|t-1} - x_{i,t|t-2} \right) = 0$ . Thus we have

$$\frac{cov_t \left( y_{t+h} - y_{i,t+h|t}^\theta, y_{i,t+h|t}^\theta - y_{i,t+h|t-1}^\theta \right)}{var_t \left( y_{i,t+h|t}^\theta - y_{i,t+h|t-1}^\theta \right)} = - \frac{\tilde{\theta}_{t,t-1} \left( 1 + \tilde{\theta}_{t,t-1} \right)}{\left( 1 + \tilde{\theta}_{t,t-1} \right)^2 + \left( \tilde{\theta}_{t-1,t-2} \rho \right)^2},$$

which we can show is decreasing in  $\tilde{\theta}_{t,t-1}$ .

We have the unconditional covariance and variance expressed as

$$\begin{aligned}
& cov \left( y_{t+h} - y_{i,t+h|t}^\theta, y_{i,t+h|t}^\theta - y_{i,t+h|t-1}^\theta \right) \\
&= \sum_{j,k,l} \left[ \Pr \left( \sigma_{\eta,t-2} = \sigma_\eta^j, \sigma_{\eta,t-1} = \sigma_\eta^k, \sigma_{\eta,t} = \sigma_\eta^l \right) cov_t \left( y_{t+h} - y_{i,t+h|t}^\theta, y_{i,t+h|t}^\theta - y_{i,t+h|t-1}^\theta; \sigma_{\eta,t-2} = \sigma_\eta^j, \sigma_{\eta,t-1} = \sigma_\eta^k, \sigma_{\eta,t} = \sigma_\eta^l \right) \right] \\
& var \left( y_{i,t+h|t}^\theta - y_{i,t+h|t-1}^\theta \right) \\
&= \sum_{j,k,l} \left[ \Pr \left( \sigma_{\eta,t-2} = \sigma_\eta^j, \sigma_{\eta,t-1} = \sigma_\eta^k, \sigma_{\eta,t} = \sigma_\eta^l \right) var_t \left( y_{i,t+h|t}^\theta - y_{i,t+h|t-1}^\theta; \sigma_{\eta,t-2} = \sigma_\eta^j, \sigma_{\eta,t-1} = \sigma_\eta^k, \sigma_{\eta,t} = \sigma_\eta^l \right) \right],
\end{aligned}$$

where  $j, k, l \in \{L, H\}$  and  $cov_t \left( y_{t+h} - y_{i,t+h|t}^\theta, y_{i,t+h|t}^\theta - y_{i,t+h|t-1}^\theta; \sigma_{\eta,t-2} = \sigma_\eta^j, \sigma_{\eta,t-1} = \sigma_\eta^k, \sigma_{\eta,t} = \sigma_\eta^l \right)$

and  $\text{var}_t \left( y_{i,t+h|t}^\theta - y_{i,t+h|t-1}^\theta; \sigma_{\eta,t-2} = \sigma_\eta^j, \sigma_{\eta,t-1} = \sigma_\eta^k, \sigma_{\eta,t} = \sigma_\eta^l \right)$  are the covariance and variance if  $\sigma_{\eta,t-2} = \sigma_\eta^j, \sigma_{\eta,t-1} = \sigma_\eta^k, \sigma_{\eta,t} = \sigma_\eta^l$ . Then we have

$$\beta_I = \sum_{j,k,l} \left[ w_I \left( \sigma_{\eta,t-2} = \sigma_\eta^j, \sigma_{\eta,t-1} = \sigma_\eta^k, \sigma_{\eta,t} = \sigma_\eta^l \right) \beta_I \left( \sigma_{\eta,t-2} = \sigma_\eta^j, \sigma_{\eta,t-1} = \sigma_\eta^k, \sigma_{\eta,t} = \sigma_\eta^l \right) \right],$$

where

$$\begin{aligned} w_I \left( \sigma_{\eta,t-2} = \sigma_\eta^j, \sigma_{\eta,t-1} = \sigma_\eta^k, \sigma_{\eta,t} = \sigma_\eta^l \right) &= \frac{\Pr \left( \sigma_{\eta,t-2} = \sigma_\eta^j, \sigma_{\eta,t-1} = \sigma_\eta^k, \sigma_{\eta,t} = \sigma_\eta^l \right) \text{var}_t \left( y_{t+h|t}^\theta - y_{i,t+h|t-1}^\theta; \sigma_{\eta,t-2} = \sigma_\eta^j, \sigma_{\eta,t-1} = \sigma_\eta^k, \sigma_{\eta,t} = \sigma_\eta^l \right)}{\text{var} \left( y_{i,t+h|t}^\theta - y_{i,t+h|t-1}^\theta \right)}, \\ \beta_I \left( \sigma_{\eta,t-2} = \sigma_\eta^j, \sigma_{\eta,t-1} = \sigma_\eta^k, \sigma_{\eta,t} = \sigma_\eta^l \right) &= \frac{\text{cov}_t \left( y_{t+h}^\theta - y_{i,t+h|t}^\theta, y_{i,t+h|t}^\theta - y_{i,t+h|t-1}^\theta; \sigma_{\eta,t-2} = \sigma_\eta^j, \sigma_{\eta,t-1} = \sigma_\eta^k, \sigma_{\eta,t} = \sigma_\eta^l \right)}{\text{var}_t \left( y_{i,t+h|t}^\theta - y_{i,t+h|t-1}^\theta; \sigma_{\eta,t-2} = \sigma_\eta^j, \sigma_{\eta,t-1} = \sigma_\eta^k, \sigma_{\eta,t} = \sigma_\eta^l \right)}. \end{aligned}$$

Since  $\beta_I \left( \sigma_{\eta,t-2} = \sigma_\eta^j, \sigma_{\eta,t-1} = \sigma_\eta^k, \sigma_{\eta,t} = \sigma_\eta^l \right) < 0$  for all  $\{\sigma_\eta^j, \sigma_\eta^k, \sigma_\eta^l\}$ , we have  $\beta_I < 0$ . For the standard DE,

$$\beta_I = -\frac{\theta(1+\theta)}{(1+\theta)^2 + (\theta\rho)^2},$$

so we have  $\beta_I < 0$  as well.

Consider now the dummy variable regression. We have

$$\begin{aligned} \gamma_I &= \sum_{j,k} \left[ w_I^L \left( \sigma_{\eta,t-2} = \sigma_\eta^j, \sigma_{\eta,t-1} = \sigma_\eta^k, \sigma_{\eta,t} = \sigma_\eta^L \right) \beta_I \left( \sigma_{\eta,t-2} = \sigma_\eta^j, \sigma_{\eta,t-1} = \sigma_\eta^k, \sigma_{\eta,t} = \sigma_\eta^L \right) \right], \\ \gamma_I + \delta_I &= \sum_{j,k} \left[ w_I^H \left( \sigma_{\eta,t-2} = \sigma_\eta^j, \sigma_{\eta,t-1} = \sigma_\eta^k, \sigma_{\eta,t} = \sigma_\eta^H \right) \beta_I \left( \sigma_{\eta,t-2} = \sigma_\eta^j, \sigma_{\eta,t-1} = \sigma_\eta^k, \sigma_{\eta,t} = \sigma_\eta^H \right) \right], \end{aligned}$$

where

$$\begin{aligned} w_I^L \left( \sigma_{\eta,t-2} = \sigma_\eta^j, \sigma_{\eta,t-1} = \sigma_\eta^k, \sigma_{\eta,t} = \sigma_\eta^L \right) &= \frac{\Pr \left( \sigma_{\eta,t-2} = \sigma_\eta^j, \sigma_{\eta,t-1} = \sigma_\eta^k, \sigma_{\eta,t} = \sigma_\eta^L \right) \text{var}_t \left( y_{t+h|t}^\theta - y_{i,t+h|t-1}^\theta; \sigma_{\eta,t-2} = \sigma_\eta^j, \sigma_{\eta,t-1} = \sigma_\eta^k, \sigma_{\eta,t} = \sigma_\eta^L \right)}{\sum_{j,k} \Pr \left( \sigma_{\eta,t-2} = \sigma_\eta^j, \sigma_{\eta,t-1} = \sigma_\eta^k, \sigma_{\eta,t} = \sigma_\eta^L \right) \text{var}_t \left( y_{t+h|t}^\theta - y_{i,t+h|t-1}^\theta; \sigma_{\eta,t-2} = \sigma_\eta^j, \sigma_{\eta,t-1} = \sigma_\eta^k, \sigma_{\eta,t} = \sigma_\eta^L \right)}, \\ w_I^H \left( \sigma_{\eta,t-2} = \sigma_\eta^j, \sigma_{\eta,t-1} = \sigma_\eta^k, \sigma_{\eta,t} = \sigma_\eta^H \right) &= \frac{\Pr \left( \sigma_{\eta,t-2} = \sigma_\eta^j, \sigma_{\eta,t-1} = \sigma_\eta^k, \sigma_{\eta,t} = \sigma_\eta^H \right) \text{var}_t \left( y_{t+h|t}^\theta - y_{i,t+h|t-1}^\theta; \sigma_{\eta,t-2} = \sigma_\eta^j, \sigma_{\eta,t-1} = \sigma_\eta^k, \sigma_{\eta,t} = \sigma_\eta^H \right)}{\sum_{j,k} \Pr \left( \sigma_{\eta,t-2} = \sigma_\eta^j, \sigma_{\eta,t-1} = \sigma_\eta^k, \sigma_{\eta,t} = \sigma_\eta^H \right) \text{var}_t \left( y_{t+h|t}^\theta - y_{i,t+h|t-1}^\theta; \sigma_{\eta,t-2} = \sigma_\eta^j, \sigma_{\eta,t-1} = \sigma_\eta^k, \sigma_{\eta,t} = \sigma_\eta^H \right)}. \end{aligned}$$

We can show that the sufficient condition for  $\delta_I < 0$  is  $\beta_I \left( \sigma_{\eta,t-2} = \sigma_\eta^L, \sigma_{\eta,t-1} = \sigma_\eta^H, \sigma_{\eta,t} = \sigma_\eta^H \right) < \beta_I \left( \sigma_{\eta,t-2} = \sigma_\eta^H, \sigma_{\eta,t-1} = \sigma_\eta^L, \sigma_{\eta,t} = \sigma_\eta^L \right)$ . In contrast, for the standard DE we have  $\delta_I = 0$ .



## H Proofs for the business cycle model

### H.1 Proof of Proposition 3

First, consider the equilibrium individual policy functions. To characterize dynamics we use a log-linear approximation of decision rules around the steady state. We take logs of the optimality condition with respect to hours in (27) and constraints  $y_{i,t} = z_{i,t}h_{i,t-1}$  and  $c_{i,t} = y_{i,t}$ :

$$\begin{aligned}\eta\hat{h}_{i,t} &= \mathbb{E}_{i,t} [-\gamma\hat{c}_{i,t+1} + \hat{z}_{i,t+1}], \\ \hat{y}_{i,t} &= \hat{z}_{i,t} + \hat{h}_{i,t-1} = \hat{c}_{i,t}.\end{aligned}$$

Substitute the constraints into the labor supply condition:

$$\begin{aligned}\eta\hat{h}_{i,t} &= \mathbb{E}_{i,t} [-\gamma\hat{c}_{i,t+1} + \hat{z}_{i,t+1}] \\ &= \mathbb{E}_{i,t} \left[ -\gamma \left( \hat{z}_{i,t+1} + \hat{h}_{i,t} \right) + \hat{z}_{i,t+1} \right] \\ \hat{h}_{i,t} &= \frac{1-\gamma}{\eta+\gamma} \mathbb{E}_{i,t} [\hat{z}_{i,t+1}] \\ &= \frac{1-\gamma}{\eta+\gamma} [\rho_A A_t + \tilde{a}_{i,t+1|t}] \\ &= \frac{1-\gamma}{\eta+\gamma} [\rho_A A_t + s_{i,t}].\end{aligned}$$

Equating the coefficients we obtain the equilibrium elasticities.

Next, consider aggregate variables. Note we have

$$\int_0^1 s_{i,t} di = 0, \quad \int_0^1 \hat{z}_{i,t} di = A_t + \int_0^1 a_{i,t} di = A_t,$$

by law of large numbers. Then

$$\begin{aligned}\hat{H}_t &= \int_0^1 \hat{h}_{i,t} di = \varepsilon \rho_A A_t + \varepsilon \int_0^1 s_{i,t} di \\ &= \varepsilon \rho_A A_t \\ \hat{Y}_t &= \int_0^1 \hat{y}_{i,t} di = \int_0^1 \hat{z}_{i,t} di + \int_0^1 \hat{h}_{i,t-1} di \\ &= A_t + \hat{H}_{t-1} \\ &= \hat{C}_t.\end{aligned}$$

## H.2 Proof of Proposition 4

Note we have

$$\int_0^1 s_{i,t}^2 di = \sigma_s^2, \quad \int_0^1 u_{a,i,t}^2 di = \sigma_{a,t-1}^2, \quad \int_0^1 a_{i,t}^2 di = \int_0^1 (s_{i,t-1} + u_{a,i,t})^2 di = \sigma_s^2 + \sigma_{a,t-1}^2.$$

Then

$$\begin{aligned} \int_0^1 (\hat{h}_{i,t} - \hat{H}_t)^2 di &= \int_0^1 (\varepsilon s_{i,t})^2 di = (\varepsilon)^2 \int_0^1 s_{i,t}^2 di \\ &= (\varepsilon)^2 \sigma_s^2, \end{aligned}$$

which is constant. Next consider the cross-sectional variance of output:

$$\begin{aligned} \int_0^1 (\hat{y}_{i,t} - \hat{Y}_t)^2 di &= \int_0^1 \left( (A_t + a_{i,t} + \hat{h}_{i,t-1}) - (A_t + \hat{H}_{t-1}) \right)^2 di \\ &= \int_0^1 (a_{i,t} + \varepsilon s_{i,t-1})^2 di \\ &= \int_0^1 (s_{i,t-1} + u_{a,i,t} + \varepsilon s_{i,t-1})^2 di \\ &= (1 + \varepsilon)^2 \int_0^1 s_{i,t-1}^2 di + \int_0^1 u_{a,i,t}^2 di \\ &= (1 + \varepsilon)^2 \sigma_s^2 + \sigma_{a,t-1}^2, \end{aligned}$$

which is increasing in  $\sigma_{a,t-1}^2$ . It follows that the cross-sectional variance of consumption:

$$\int_0^1 (\hat{c}_{i,t} - \hat{C}_t)^2 di = (1 + \varepsilon)^2 \sigma_s^2 + \sigma_{a,t-1}^2,$$

is increasing in  $\sigma_{a,t-1}^2$  as well.

## H.3 Proof of Proposition 5

First, consider the equilibrium individual policy functions. As in the RE solution, to characterize dynamics we use a log-linear approximation of decision rules around the steady state. We take logs of the optimality condition with respect to hours in (28) and constraints  $y_{i,t} = z_{i,t} h_{i,t-1}$  and  $c_{i,t} = y_{i,t}$ :

$$\begin{aligned} \eta \hat{h}_{i,t}^\theta &= \mathbb{E}_{i,t}^\theta [-\gamma \hat{c}_{i,t+1}^{RE} + \hat{z}_{i,t+1}] \\ \hat{y}_{i,t}^\theta &= \hat{z}_{i,t} + \hat{h}_{i,t-1}^\theta = \hat{c}_{i,t}^\theta. \end{aligned}$$

Substitute the constraints into the labor supply condition:

$$\begin{aligned}
\eta \hat{h}_{i,t}^\theta &= (1 + \tilde{\theta}_{t,t-J}) \mathbb{E}_{i,t} [-\gamma \hat{c}_{i,t+1}^{RE} + \hat{z}_{i,t+1}] - \tilde{\theta}_{t,t-J} \mathbb{E}_{i,t-J} [-\gamma \hat{c}_{i,t+1}^{RE} + \hat{z}_{i,t+1}] \\
\eta \hat{h}_{i,t}^\theta &= (1 + \tilde{\theta}_{t,t-J}) \mathbb{E}_{i,t} \left[ -\gamma \left( \hat{z}_{i,t+1} + \hat{h}_{i,t}^\theta \right) + \hat{z}_{i,t+1} \right] \\
&\quad - \tilde{\theta}_{t,t-J} \mathbb{E}_{i,t-J} \left[ -\gamma \left( \hat{z}_{i,t+1} + \hat{h}_{i,t}^{RE} \right) + \hat{z}_{i,t+1} \right] \\
\left[ \eta + \left( 1 + \tilde{\theta}_{t,t-J} \right) \gamma \right] \hat{h}_{i,t}^\theta &= (1 + \tilde{\theta}_{t,t-J}) (1 - \gamma) \mathbb{E}_{i,t} [\hat{z}_{i,t+1}] - \tilde{\theta}_{t,t-J} (1 - \gamma) \mathbb{E}_{i,t-J} [\hat{z}_{i,t+1}] + \tilde{\theta}_{t,t-J} \gamma \mathbb{E}_{i,t-J} [\hat{h}_{i,t}^{RE}] \\
\left[ \eta + \left( 1 + \tilde{\theta}_{t,t-J} \right) \gamma \right] \hat{h}_{i,t}^\theta &= (1 + \tilde{\theta}_{t,t-J}) (1 - \gamma) [\rho_A A_t + s_{i,t}] \\
&\quad - \tilde{\theta}_{t,t-J} (1 - \gamma) \rho_A^{J+1} A_{t-J} + \tilde{\theta}_{t,t-J} \gamma [\varepsilon \rho_A^{J+1} A_{t-J}] \\
\hat{h}_{i,t}^\theta &= \frac{(1 + \tilde{\theta}_{t,t-J}) (1 - \gamma)}{\eta + \left( 1 + \tilde{\theta}_{t,t-J} \right) \gamma} \rho_A A_t + \frac{(1 + \tilde{\theta}_{t,t-J}) (1 - \gamma)}{\eta + \left( 1 + \tilde{\theta}_{t,t-J} \right) \gamma} s_{i,t} \\
&\quad - \frac{\tilde{\theta}_{t,t-J} \gamma}{\eta + \left( 1 + \tilde{\theta}_{t,t-J} \right) \gamma} \left[ \frac{1 - \gamma}{\eta + \gamma} \right] \rho_A^{J+1} A_{t-J},
\end{aligned}$$

where the effective diagnosticity parameter  $\tilde{\theta}_{t,t-J}$  is given by (31). Equating the coefficients we obtain the equilibrium elasticities. As in the RE economy, we obtain equilibrium aggregate variables by simply aggregating the individual policy functions.

## H.4 Proof of Proposition 6

Consider  $R_{t+1|t,t-J}$ :

$$\begin{aligned}
R_{t+1|t,t-J} &= \frac{\mathbb{V}_{i,t} (-\gamma \hat{c}_{i,t+1}^{RE} + \hat{z}_{i,t+1})}{\mathbb{V}_{i,t-J} (-\gamma \hat{c}_{i,t+1}^{RE} + \hat{z}_{i,t+1})} \\
&= \frac{\mathbb{V}_{i,t} \left( -\gamma \left( \hat{z}_{i,t+1} + \hat{h}_{i,t}^\theta \right) + \hat{z}_{i,t+1} \right)}{\mathbb{V}_{i,t-J} \left( -\gamma \left( \hat{z}_{i,t+1} + \hat{h}_{i,t}^{RE} \right) + \hat{z}_{i,t+1} \right)} \\
&= \frac{\mathbb{V}_{i,t} \left( (1 - \gamma) \hat{z}_{i,t+1} - \gamma \hat{h}_{i,t}^\theta \right)}{\mathbb{V}_{i,t-J} \left( (1 - \gamma) \hat{z}_{i,t+1} - \gamma \hat{h}_{i,t}^{RE} \right)},
\end{aligned}$$

where the numerator is

$$\mathbb{V}_{i,t} \left( (1 - \gamma) [\rho_A A_t + u_{A,t+1} + s_{i,t} + u_{a,i,t+1}] - \gamma \hat{h}_{i,t}^\theta \right) = (1 - \gamma)^2 (\sigma_A^2 + \sigma_{a,t}^2),$$

which is increasing in  $\sigma_{a,t}^2$ . Thus  $R_{t+1|t,t-J}$  and in turn  $\tilde{\theta}_{t,t-J}$  are increasing in  $\sigma_{a,t}^2$ .

## H.5 Proof of Proposition 7

First consider the cross-sectional variance of hours. Defining  $\varepsilon_{s,t}^\theta \equiv \frac{(1+\tilde{\theta}_{t,t-J})(1-\gamma)}{\eta+(1+\tilde{\theta}_{t,t-J})\gamma}$ , we have

$$\begin{aligned} \int_0^1 \left( \widehat{h}_{i,t}^\theta - \widehat{H}_t^\theta \right)^2 di &= \int_0^1 \left( \varepsilon_{s,t}^\theta s_{i,t} \right)^2 di = \left( \varepsilon_{s,t}^\theta \right)^2 \int_0^1 s_{i,t}^2 di \\ &= \left[ \frac{(1+\tilde{\theta}_{t,t-J})(1-\gamma)}{\eta+(1+\tilde{\theta}_{t,t-J})\gamma} \right]^2 \sigma_s^2, \end{aligned}$$

which is increasing in  $\tilde{\theta}_{t,t-J}$ . Next consider the cross-sectional variance of output:

$$\begin{aligned} \int_0^1 \left( \widehat{y}_{i,t}^\theta - \widehat{Y}_t^\theta \right)^2 di &= \int_0^1 \left( \left( A_t + a_{i,t} + \widehat{h}_{i,t-1}^\theta \right) - \left( A_t + \widehat{H}_{t-1}^\theta \right) \right)^2 di \\ &= \int_0^1 \left( s_{i,t-1} + u_{a,i,t} + \varepsilon_{s,t-1}^\theta s_{i,t-1} \right)^2 di \\ &= \left( 1 + \left[ \frac{(1+\tilde{\theta}_{t,t-J})(1-\gamma)}{\eta+(1+\tilde{\theta}_{t,t-J})\gamma} \right] \right)^2 \sigma_s^2 + \sigma_{a,t-1}^2 \end{aligned}$$

which is increasing in  $\tilde{\theta}_{t,t-J}$  and  $\sigma_{a,t-1}^2$ . It follows that the cross-sectional variance of consumption:

$$\int_0^1 \left( \widehat{c}_{i,t}^\theta - \widehat{C}_t^\theta \right)^2 di \left( 1 + \left[ \frac{(1+\tilde{\theta}_{t,t-J})(1-\gamma)}{\eta+(1+\tilde{\theta}_{t,t-J})\gamma} \right] \right)^2 \sigma_s^2 + \sigma_{a,t-1}^2$$

is increasing in  $\tilde{\theta}_{t,t-J}$  and  $\sigma_{a,t-1}^2$  as well.

## H.6 Proof of Proposition 8

First, we solve for the log-linearized RE decision rules under the tax policy. The optimality conditions are

$$\begin{aligned} \eta \widehat{h}_{i,t} &= \mathbb{E}_{i,t} [-\gamma \widehat{c}_{i,t+1} + A_{t+1} + (1-\tau)a_{i,t+1}] \\ \widehat{y}_{i,t} &= \widehat{z}_{i,t} + \widehat{h}_{i,t-1} \\ \widehat{c}_{i,t} + \tau a_{i,t} &= \widehat{y}_{i,t}. \end{aligned}$$

Substitute the constraints into labor supply conditions:

$$\begin{aligned}
\eta \widehat{h}_{i,t} &= \mathbb{E}_{i,t} [-\gamma \widehat{c}_{i,t+1} + A_{t+1} + (1-\tau)a_{i,t+1}] \\
&= \mathbb{E}_{i,t} \left[ -\gamma \left( A_{t+1} + (1-\tau)a_{i,t+1} + \widehat{h}_{i,t} \right) + A_{t+1} + (1-\tau)a_{i,t+1} \right] \\
\widehat{h}_{i,t} &= \frac{1-\gamma}{\eta+\gamma} \mathbb{E}_{i,t} [A_{i,t+1}] + \frac{1-\gamma}{\eta+\gamma} (1-\tau) \mathbb{E}_{i,t} [a_{i,t+1}] \\
&= \frac{1-\gamma}{\eta+\gamma} [\rho_A A_t + (1-\tau)\widetilde{a}_{i,t+1|t}] \\
&= \frac{1-\gamma}{\eta+\gamma} [\rho_A A_t + (1-\tau)s_{i,t}]
\end{aligned}$$

Equilibrium output and consumption follow immediately as

$$\widehat{y}_{i,t} = \widehat{z}_{i,t} + \widehat{h}_{i,t-1} = A_t + a_{i,t} + \widehat{h}_{i,t-1}, \quad (41)$$

$$\widehat{c}_{i,t} = \widehat{y}_{i,t} - \tau a_{i,t} = A_t + (1-\tau)a_{i,t} + \widehat{h}_{i,t-1}. \quad (42)$$

Next, consider the log-linearized SDE decision rules under the tax policy. To characterize dynamics we use a log-linear approximation of decision rules around the steady state. The optimality conditions are

$$\begin{aligned}
\eta \widehat{h}_{i,t}^\theta &= \mathbb{E}_{i,t}^\theta [-\gamma \widehat{c}_{i,t+1}^{RE} + A_{t+1} + (1-\tau)a_{i,t+1}], \\
\widehat{y}_{i,t}^\theta &= \widehat{z}_{i,t} + \widehat{h}_{i,t-1}^\theta, \\
\widehat{c}_{i,t}^\theta + \tau a_{i,t} &= \widehat{y}_{i,t}^\theta.
\end{aligned}$$

Substitute the constraints into the labor supply condition:

$$\begin{aligned}
\eta \widehat{h}_{i,t}^\theta &= (1 + \widetilde{\theta}_{t,t-J}) \mathbb{E}_{i,t} [-\gamma \widehat{c}_{i,t+1}^{RE} + A_{t+1} + (1-\tau)a_{i,t+1}] - \widetilde{\theta}_{t,t-J} \mathbb{E}_{i,t-J} [-\gamma \widehat{c}_{i,t+1}^{RE} + A_{t+1} + (1-\tau)a_{i,t+1}] \\
\eta \widehat{h}_{i,t}^\theta &= (1 + \widetilde{\theta}_{t,t-J}) \mathbb{E}_{i,t} \left[ -\gamma \left( A_{t+1} + (1-\tau)a_{i,t+1} + \widehat{h}_{i,t}^\theta \right) + A_{t+1} + (1-\tau)a_{i,t+1} \right] \\
&\quad - \widetilde{\theta}_{t,t-J} \mathbb{E}_{i,t-J} \left[ -\gamma \left( A_{t+1} + (1-\tau)a_{i,t+1} + \widehat{h}_{i,t}^{RE} \right) + A_{t+1} + (1-\tau)a_{i,t+1} \right] \\
\left[ \eta + \left( 1 + \widetilde{\theta}_{t,t-J} \right) \gamma \right] \widehat{h}_{i,t}^\theta &= (1 + \widetilde{\theta}_{t,t-J}) (1-\gamma) \mathbb{E}_{i,t} [A_{t+1} + (1-\tau)a_{i,t+1}] \\
&\quad - \widetilde{\theta}_{t,t-J} (1-\gamma) \mathbb{E}_{i,t-J} [A_{t+1} + (1-\tau)a_{i,t+1}] + \widetilde{\theta}_{t,t-J} \gamma \mathbb{E}_{i,t-J} [\widehat{h}_{i,t}^{RE}] \\
\left[ \eta + \left( 1 + \widetilde{\theta}_{t,t-J} \right) \gamma \right] \widehat{h}_{i,t}^\theta &= (1 + \widetilde{\theta}_{t,t-J}) (1-\gamma) [\rho_A A_t + (1-\tau)s_{i,t}] \\
&\quad - \widetilde{\theta}_{t,t-J} (1-\gamma) \rho_A^{J+1} A_{t-J} + \widetilde{\theta}_{t,t-J} \gamma \varepsilon \rho_A^{J+1} A_{t-J} \\
\widehat{h}_{i,t}^\theta &= \frac{(1 + \widetilde{\theta}_{t,t-J}) (1-\gamma)}{\eta + (1 + \widetilde{\theta}_{t,t-J}) \gamma} \rho_A A_t + \frac{(1 + \widetilde{\theta}_{t,t-J}) (1-\gamma)}{\eta + (1 + \widetilde{\theta}_{t,t-J}) \gamma} (1-\tau)s_{i,t} \\
&\quad - \frac{\widetilde{\theta}_{t,t-J} \eta}{\eta + (1 + \widetilde{\theta}_{t,t-J}) \gamma} \left[ \frac{1-\gamma}{\eta+\gamma} \right] \rho_A^{J+1} A_{t-J},
\end{aligned}$$

where the effective diagnosticity parameter  $\tilde{\theta}_{t,t-J}$  is given by (31).

Consider  $R_{t+1|t,t-J}$ :

$$\begin{aligned}
R_{t+1|t,t-J} &= \frac{\mathbb{V}_{i,t} \left( -\gamma \widehat{c}_{i,t+1}^{RE} + A_{t+1} + (1-\tau)a_{i,t+1} \right)}{\mathbb{V}_{i,t-J} \left( -\gamma \widehat{c}_{i,t+1}^{RE} + A_{t+1} + (1-\tau)a_{i,t+1} \right)} \\
&= \frac{\mathbb{V}_{i,t} \left( -\gamma \left( A_{t+1} + (1-\tau)a_{i,t+1} + \widehat{h}_{i,t}^\theta \right) + A_{t+1} + (1-\tau)a_{i,t+1} \right)}{\mathbb{V}_{i,t-J} \left( -\gamma \left( A_{t+1} + (1-\tau)a_{i,t+1} + \widehat{h}_{i,t}^{RE} \right) + A_{t+1} + (1-\tau)a_{i,t+1} \right)} \\
&= \frac{\mathbb{V}_{i,t} \left( (1-\gamma) (A_{t+1} + (1-\tau)a_{i,t+1}) - \gamma \widehat{h}_{i,t}^\theta \right)}{\mathbb{V}_{i,t-J} \left( (1-\gamma) (A_{t+1} + (1-\tau)a_{i,t+1}) - \gamma \widehat{h}_{i,t}^{RE} \right)}
\end{aligned}$$

where the numerator is

$$\begin{aligned}
&\mathbb{V}_{i,t} \left( (1-\gamma) [\rho_A A_t + u_{A,t+1} + (1-\tau)s_{i,t} + (1-\tau)u_{a,i,t+1}] - \gamma \widehat{h}_{i,t}^\theta \right) \\
&= (1-\gamma)^2 (\sigma_A^2 + (1-\tau)^2 \sigma_{a,t}^2),
\end{aligned}$$

which is increasing in  $\sigma_{a,t}^2$  but also a change in  $\sigma_{a,t}^2$  have a smaller impact when the progressivity  $\tau$  is higher. Thus a higher  $\tau$  is associated with a smaller increase in  $R_{t+1|t,t-J}$  and  $\tilde{\theta}_{t,t-J}$ .