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Nonlinear Effects of Fiscal Policy over the Business Cycle

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Abstract

Is fiscal policy more effective, measured by the government spending multiplier or the tax multiplier, when the economy is "weak" than when it is "strong?" Results in the empirical literature have been mixed. Using local projection techniques, I estimate the impulse responses of real output and real government spending to a shock to military spending. I also estimate the responses of real output and real tax revenues to a shock in taxes. In both cases, I allow for nonlinearity in the effects according to whether the unemployment rate is above or below a given threshold value. I find that raising the threshold unemployment rate incrementally leads to a higher multiplier on government purchases in the "bad" state of the world, though it is not significantly greater than 1. The results for tax changes are even less precisely estimated, due to lower instrument relevance of the exogenous tax shocks.

Keywords: Multiplier, Fiscal Policy, Local Projections

JEL Codes: E62, E63

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