Accepted Manuscript

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PII: S0014-2921(18)30074-6
DOI: 10.1016/j.euroecorev.2018.05.002
Reference: EER 3146

To appear in: *European Economic Review*

Received date: 11 August 2017
Accepted date: 6 May 2018

Please cite this article as: Eric Sims, Jonathan Wolff, The State-Dependent Effects of Tax Shocks, *European Economic Review* (2018), doi: 10.1016/j.euroecorev.2018.05.002

The State-Dependent Effects of Tax Shocks*

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May 24, 2018

Abstract

This paper studies the state-dependent effects of shocks to tax rates. We begin with a stylized model in which clean analytical expressions are available. The model predicts that a tax rate cut is most stimulative for output in periods in which output is relatively high. The model is also used to discuss some conceptual issues related to the construction of tax multipliers. We then consider a medium-scale DSGE model with tax rates on labor and capital income and on consumption. The model is solved via a third order perturbation. Consonant with the intuition from the analytical model, tax multipliers for all three types of tax rates vary significantly across states, and are most stimulative for output in states in which output is high. To evaluate the normative desirability of tax cuts as a tool to combat recessions, we also study the properties of the tax cut welfare multiplier, which measures the change in aggregate welfare conditional on a tax rate change. In contrast to output multipliers, welfare multipliers are found to be countercyclical. A number of extensions and modifications are considered and our conclusions are generally robust.

JEL Classification: E30, E60, E62

Keywords: fiscal policy, tax policy, business cycle, welfare

*We are particularly grateful to Tim Fuerst, Eric Leeper, Robert Lester, Michael Pries, Morten Ravn, Nam Vu, Todd Walker, participants at the Fall 2014 Midwest Macro Conferences, seminar participants at the University of Michigan, the University of Notre Dame, Miami University, Bowling Green State University, and several anonymous referees for several comments which have substantially improved the paper. The usual disclaimers apply.

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