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Corporate Taxes and Vertical Tax Externalities: Evidence from Narrative Federal Tax Shocks

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Corporate Taxes and Vertical Tax Externalities: Evidence from Narrative**Federal Tax Shocks**Yaniv Reingewertz^a*Abstract:*

The empirical aspects of vertical tax externalities have been studied fairly extensively, but with little consensus – a fact that may relate to difficulties in isolating exogenous components in tax setting policy. Adopting the case of the US and using a narrative approach (Romer and Romer 2010), I study the vertical effects of federal tax shocks. I find that vertical tax externalities are modest in their size and are only present in corporate taxation. In particular, I estimate that a \$1 billion increase in federal tax revenues reduces total state corporate tax revenues by approximately \$27 million. Non-corporate state tax revenues do not seem to be affected by federal tax shocks. Taking a state micro-level approach and using firm-level business activity data, I show that the findings point to the erosion of states' corporate tax bases.

JEL codes: E62, H20, H71, H77

Keywords: Vertical tax externality, narrative tax shocks, federal taxes, state taxes.

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