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State-Dependent Macroeconomic Effects of Tax Changes

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ABSTRACT

This paper provides evidence on the state-dependent macroeconomic effects of tax liability changes in the US. We estimate a state-dependent model where the state of the economy is measured by unemployment rate, economic growth, and level of uncertainty in the economy. Our estimates show that while tax policy becomes more effective during low unemployment states and expansions (good times), it has a lower impact on output when uncertainty is low (tranquil times). Thus, while our identified tax shocks based on narrative records are indeed unrelated to the state of the economy, the macroeconomic effects of the shocks are different depending on the state of the economy. Results are shown to be robust to many alternative specifications. We show that this nonlinearity in the output responses is primarily driven by lumpy investment. In addition, we use our estimates to project the near-term growth impact of the Tax Cuts and Jobs Act (TCJA) and predict a level of GDP to be 2.06 percent higher by 2020.

KEYWORDS Narrative approach; Fiscal policy; State-dependent

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