VAR-based and Narrative Measures of the Tax Multiplier∗

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Abstract

This paper argues that the best approach to measure tax multipliers is to include in a fiscal VAR the structural shocks identified using information independent from the VAR—i.e. the shocks constructed using a narrative method. We first show that "narrative" shocks are valid shocks in a fiscal VAR, i.e. they are orthogonal to the relevant information set. We then show that the direct inclusion of narrative shocks in a fiscal VAR delivers estimates of the tax multiplier that are similar to those obtained within the traditional fiscal VAR approach. The use of narrative shocks has a big advantage: it does not require the inversion of the moving-average representation of a VAR for the identification of the relevant shocks. Therefore, within this framework, fiscal multipliers can be identified and estimated even when the MA representation of the VARs is not invertible—the relevant case in the presence of fiscal foresight, i.e. when agents receive signals on the tax changes they will face in the future.

Keywords: fiscal policy, public debt, government budget constraint, VAR models

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1 Introduction

This paper argues that the best approach to measure the size of the tax multiplier is to identify structural shocks to government revenues via the narrative method (Romer and Romer 2009, R&R in what follows) and then study their effects on macro variables by including them in fiscal VAR. This is possible because shocks identified via the narrative method are orthogonal to the relevant information set in a fiscal VAR and they can be therefore considered as perfectly valid structural shocks.

Using this approach we solve an apparent puzzle in the measurement of tax multipliers. Multipliers derived from the analysis of shocks identified within a VAR are surprisingly different from multipliers associated with shocks identified via the narrative method. R&R, using U.S. data and studying the post World War II period, find a multiplier significantly greater than one: a tax increase of 1% of U.S. GDP reduces output over the next three years by nearly 3%. Instead, authors who analyze VAR shocks typically find a multiplier of about one. We show that this difference is not explained by a difference in the shocks (VAR vs. narrative) but by the different models used to estimate their effects on macro variables. If the effects of shocks identified by the narrative method are analyzed in the context of a multivariate dynamic model (rather than using a limited information single-equation approach), then the multiplier is not different from that obtained in the traditional fiscal VAR approach.

Moreover, the inclusion in a fiscal VAR of shocks identified via the narrative method does not require the inversion of the moving-average representation of a VAR. Therefore, fiscal multipliers can be validly identified and estimated even when the MA representation of the VAR is not invertible—the relevant case in the presence of fiscal foresight, i.e. when agents receive signals on the tax changes they will face in the future.

We start by replicating the apparently contradictory results delivered by the two main approaches to the estimation of tax multipliers. R&R, as we said, identify tax shocks from the "narrative" of Presidential speeches and Congressional records. This analysis allows them to separate legislated changes in taxes between those they consider endogenous (induced by short-run counter-cyclical concerns or adopted as a response to changes in government spending) and those they judge exogenous (associated with a political shift, or adopted in response to the state of government debt, or in the attempt to raise long-run economic growth). For the post World War II period they find, as we already mentioned, a multiplier significantly greater than one. The fiscal VAR approach identifies tax shocks either exploiting the fact that it typically takes longer than one quarter for discretionary fiscal policy to respond to news
in macroeconomic variables and using institutional information on the elasticities of
tax revenues and government spending to macro variables (Blanchard and Perotti
2002, Perotti, 2008, from here onwards we refer to both articles as B&P), or imposing
restrictions on the sign of impulse responses (Mountford and Uhlig 2002) or relying
on a Choleski ordering (Fatas and Mihov 2001). These identification schemes deliver
similar tax multipliers—typically close to one.

There are also important differences in the structural stability of these estimates
in the post World War II period. The B&P results for the entire sample (1960 to
2001) average very different responses before and after 1980. In the first part of the
sample tax cuts have a positive and significant effect on output, with a multiplier only
slightly smaller compared with R&R (around 2.6 at a three year horizon). After 1980
the effect turns negative and significant with a multiplier that is similar in absolute
value. On the contrary the R&R evidence on the size of tax multipliers is stable over
the two sub-samples.

This contrasting evidence is summarized in Figure 1, where we report the effect
on output of an exogenous shift in U.S. Federal tax liabilities equivalent to 1% of U.S.
GDP as computed by R&R and as derived form the application of the B&P identi-
cation scheme to a closed-economy fiscal VAR which includes government expenditure,
government receipts, output growth, inflation, and the average cost of servicing the
debt.

Could these differences be due to fact that structural VAR’s fail to identify truly
exogenous shifts in taxes? Figure 2 shows that the exogenous shocks identified by the
two alternative methods are indeed quite different. Their correlation over the entire
sample is 0.22 and the two identification strategies lead to a substantial disagreement
as to when the largest policy shifts occurred. "Shocks" measure exogenous shifts
in fiscal policy, but there is no reason why such measure should be unique. Differ-
ent identification approaches could produce different time series of tax shocks, each
exogenous and thus each legitimate. In other words, alternative valid instruments,
although different, could deliver the same estimate of the tax multiplier.

The view that alternative ways of identifying fiscal shocks could be the reason
why estimated multipliers differ is reminiscent of the debate on the identification
of monetary policy shocks. Rudebusch (1998) criticizes the VAR-based analysis of
the effects of monetary policy shocks observing that shocks identified from structural
VAR’s—typically from a regression of the Fed funds rate on an assortment of macro
variables and therefore via a recursive identification scheme between macroeconomic
variables and monetary policy—bear little correlation with shocks to the Fed funds
rate derived from forward-looking financial markets (the Fed funds future). He thus concludes that monetary policy shocks identified from a VAR make no sense. Sims (1998) replies observing that in a multivariate framework measures of the same variables that bear little correlation with one another can produce identical transmission mechanisms. He suggests, as an example, the measurement of the effects of supply shocks in a simple demand-supply model. Two variables can shift the supply function, weather and insect density. Consider two alternative instrumenting strategies: each excludes one instrument. As both supply shifters are valid instruments, the two models will produce valid and equivalent estimates of the structural parameters, despite the fact that they use different instruments.

Thus, in order to compare tax multipliers obtained from shocks estimated in a VAR with those obtained using "narrative" shocks, the obvious thing to do consists in including narrative shocks in the VAR model and then compare the two impulse responses. In the case of monetary policy shocks VAR and non-VAR shocks deliver the same description of the monetary transmission mechanism (Bagliano and Favero 1999).

The paper is organized as follows. First, we show that the R&R narrative shocks are valid shocks from the point of view of a fiscal VAR, i.e. they are orthogonal to the information set used to construct the conditional distribution of the variables included in a traditional fiscal VAR. In the light of this evidence we estimate the tax multiplier by treating the shocks identified via the narrative method as structural shocks in a fiscal VAR. This is the natural way to estimate tax multipliers since one of the variables included in traditional fiscal VAR’s is government revenue, and what the narrative approach does is precisely to identify exogenous shocks to government revenue. Using the R&R narrative shocks in a multivariate dynamic model we obtain estimates of the tax multiplier that are very similar to those obtained estimating a traditional fiscal VAR. We thus show that the apparent puzzle in the measurement of tax multipliers depends on the limited information approach used by R&R. Finally, we consider the possibility of measurement error in the R&R shocks due to the presence of implementation lags in fiscal policy. In particular, we illustrate how the method of coupling a fiscal VAR specification with the identification of structural fiscal shocks independent from the VAR is particularly advantageous in presence of fiscal foresight. We adopt the taxonomy of the R&R tax shocks into anticipated and unanticipated proposed by Mertens and Ravn (2008) to derive fiscal multipliers associated to unanticipated tax shocks and to anticipated tax shocks, announced at time t with some implementation lag.
2 VAR-based and Narrative Measures of the tax multiplier

This section proposes a way to estimate tax multipliers based on merging the fiscal VAR approach with the narrative identification of shocks to government revenue. We start by describing how Figures 1 and 2 were constructed.

2.1 VAR Approach

We first consider the structural VAR estimated in B&P. Tax multipliers are obtained estimating a vector autoregression of the form:

\[ Z_t = C_1 Z_{t-1} + u_t \]  

where \( i_t \) is the average nominal interest cost of the public debt, \( y_t \) is level of real GDP, \( \Delta p_t \) is inflation, \( t_t \) and \( g_t \) are, respectively, the logs of government revenues and government expenditures net of interest. This seems to be a natural choice for a minimal set of variables to be included in the analysis of the effects of fiscal policy. An additional reason for choosing this particular set of variables—as we shall explain later—is that they fully describe the dynamics of the public debt.

Structural VAR’s identify fiscal shocks imposing restrictions that allow to recover uniquely the structural shocks of interest from the reduced form residuals, \( u_t \). The innovations in the reduced form equations for taxes and government spending, \( u_t^g \) and \( u_t^t \), contain three terms: (i) the response of taxes and government spending to fluctuations in macroeconomic variables, such as output and inflation, that is implied by the presence of automatic stabilizers; (ii) the discretionary response of fiscal policy to news in macro variables, and (iii) truly exogenous shifts in taxes and spending, the shocks we wish to identify. B&P exploit the fact that it typically takes longer than a quarter for discretionary fiscal policy to respond to news in macroeconomic variables: at quarterly frequency the contemporaneous discretionary response of fiscal policy to macroeconomic data can thus be assumed to be zero. To identify the component of

\(^1\)For simplicity we consider a first order VAR. VARs of any order can be re-parametrized as a first order VAR, using a stacked representation.

\(^2\)For this reason, our choice of variables is slightly different from that of B&P. See the Data Appendix for a full description of the construction of our data-set.
$u_t^g$ and $u_t^t$ which corresponds to automatic stabilizers they use institutional information on the elasticities of tax revenues and government spending to macroeconomic variables. They thus identify the structural shocks to $g$ and $t$ by imposing on the matrices $A$ and $B$ that determine the mapping from the VAR innovations $u$ to the structural shocks $e$ ($Au_t = Be_t$) the following restrictions:

\[
\begin{bmatrix}
1 & 0 & a_{gy} & a_g\Delta p & a_{gi} \\
0 & 1 & a_{ty} & a_t\Delta p & a_{ti} \\
a_{31} & a_{32} & 1 & 0 & 0 \\
a_{41} & a_{42} & a_{43} & 1 & 0 \\
a_{51} & a_{52} & a_{53} & a_{54} & 1
\end{bmatrix}
\begin{bmatrix}
\begin{bmatrix} u_t^g \\ u_t^t \end{bmatrix} \\
\end{bmatrix} = 
\begin{bmatrix}
\begin{bmatrix} b_{11} & 0 & 0 & 0 & 0 \\ b_{21} & b_{22} & 0 & 0 & 0 \\
0 & 0 & b_{33} & 0 & 0 \\
0 & 0 & 0 & b_{44} & 0 \\
0 & 0 & 0 & 0 & b_{55}
\end{bmatrix} \\
\end{bmatrix} \begin{bmatrix}
\begin{bmatrix} e_t^g \\ e_t^t \end{bmatrix} \\
\end{bmatrix}
\]

where $e_t^i$ ($i = 1, 2, 3$) are non-fiscal shocks and have no structural interpretation. Since $a_{gy}, a_g\Delta p, a_{gi}, a_{ty}, a_t\Delta p$ and $a_{ti}$ are identified using external information $^3$, there are only 15 parameters to be estimated. As there are also 15 different elements in the variance-covariance matrix of the 5-equation VAR innovations: the model is just identified. The $e_t^i$ ($i = 1, 2, 3$) are derived by imposing a recursive scheme on the bottom three rows of $A$ and $B$; however, the identification of the two fiscal shocks—the only ones that we shall use to compute impulse responses—is independent of this assumption. Finally, the identification assumption imposes $b_{12} = 0$. $^4$

Figure 1 reports, under the label B&P impulse responses the responses of the level of output to a one-period shock in $e_t^i$ of the size of 1% of GDP. In Figure 2 we report under the label Blanchard-Perotti VAR shocks the time-series of $e_t^i$.

$^3$The elasticities of taxes and government spending with respect to output, inflation and interest rates used in the identification have been updated in Perotti (2008) and are

| Elasticities of government revenues and expenditures |
|---------------------------------|----------|---------|------|-------|------|
|                                 | $a_{gy}$ | $a_g\Delta p$ | $a_{gi}$ | $a_{ty}$ | $a_t\Delta p$ | $a_{ti}$ |
| Entire sample                   | 0        | -0.5     | 1.85  | 1.25   | 0     |
| 1960:1-1979:4                   | 0        | -0.5     | 1.75  | 1.09   | 0     |
| 1980:1-2006:2                   | 0        | -0.5     | 1.97  | 1.40   | 0     |

$^4$B&P provide robustness checks for this assumption by setting $b_{21} = 0$ and estimating $b_{12}$. We have also experimented with this alternative option. In practice, as the top left corner of the $B$ matrix is not statistically different from a diagonal matrix, the assumption $b_{12} = 0$ is irrelevant to determine the shape of impulse response functions.
2.2 The Narrative Approach

R&R construct a time-series of shocks to government revenues without the need to estimate a model. They consult the narrative record, such as Presidential speeches and Congressional reports, to identify the size, timing, and principal motivation for all major postwar tax policy actions. They then classify legislated tax changes into *endogenous* (those induced by short-run countercyclical concerns and those taken because of change in government spending) and *exogenous* (those that are responses to the state of government debt or to concerns about long-run economic growth).

Having constructed a time series of exogenous shifts in taxes, $e_{t-i}^\text{RR}$—where each $e_{t-i}^\text{RR}$ measures the impact of a tax change at the time it was implemented ($t-i$) on tax liabilities at time $t$—R&R measure their effect on output, $y_t$, estimating, using quarterly data and ordinary least squares, a single equation of the form

$$\Delta y_t = a + \sum_{j=0}^{M} b_i e_{t-j}^\text{RR} + v_t \quad (2)$$

where $\Delta y_t$ is real GDP growth. Exogenous tax shocks are measured as a percentage of GDP. So the response of the level of output at time $t+i$ to a one-period shock of the size of 1% of GDP is measured by the sum of the $b_i$ coefficients. This is what we report in Figure 1 under the label R&R. As in R&R we have chosen $M = 12$. Figure 2 reports the time series of $e_t^\text{RR}$. Note that the correlation between $e_t^\text{R}$ and $e_t^\text{RR}$ is not very high (0.22), although it is statistically different from zero ($t - 3.22$). Moreover the evidence from important (in quantitative terms) episodes is mixed in the sense that we have both matches and mis-matches.

3 Understanding the difference

To understand the difference between the narrative and the VAR approaches we need a common "encompassing" framework. We construct it starting from the structural representation of the VAR

$$AZ_t = CZ_{t-1} + Be_t \quad (3)$$

The MA representation of (3) is

$$Z_t = \Gamma(L)e_t \quad (4)$$

where $\Gamma(L) \equiv \frac{A^{-1}B}{1-A^{-1}C}$. The MA representation is not directly estimated in the VAR, but it can be derived by inversion after having estimated (3).
We now re-write (4) as follows

\[ Z_t = \sum_{j=0}^{M} \Gamma_0^{j} e_{t-j} + \Gamma_1^{M+1} Z_{t-M+1} \]
\[ \Gamma_0 \equiv A^{-1} B, \quad \Gamma_1 \equiv A^{-1} C. \]

and extract from the above system the equation for output growth

\[ \Delta y_t = \sum_{j=0}^{M} \gamma_{y,t}^{y,x} e_{t-j} + \sum_{j=0}^{M} \gamma_{y,g}^{y,x} e_{t-j} + \sum_{j=0}^{M} \gamma_{y,y}^{y,x} e_{t-j} + \sum_{j=0}^{M} \gamma_{y,i}^{y,x} e_{t-j} + \Gamma_1^{M+1} Z_{t-M+1} \]

where

\[ \gamma_{y,x}^{y,t} = s^x \Gamma_0^{i} s^y, \quad x = t, g, y, \Delta p, i \]
\[ s^g = \begin{bmatrix} 1 & 0 & 0 & 0 & 0 \end{bmatrix}, \quad s^t = \begin{bmatrix} 0 & 1 & 0 & 0 & 0 \end{bmatrix} \]
\[ s^y = \begin{bmatrix} 0 & 0 & 1 & 0 & 0 \end{bmatrix}, \quad s^{\Delta p} = \begin{bmatrix} 0 & 0 & 0 & 1 & 0 \end{bmatrix} \]
\[ s^i = \begin{bmatrix} 0 & 0 & 0 & 1 & 0 \end{bmatrix} \]

To compare (5) with (2), the equation estimated by R&R, we need to spell out the relation between the structural tax shocks identified from the VAR and the structural tax shocks constructed using the narrative method. We assume

\[ e_{t}^{l} = e_{t}^{RR} + \varepsilon_{t} \]
\[ \varepsilon_{t} \sim i.i.d. \left(0, \sigma_{\varepsilon}^{2}\right) \]

i.e. we assume that the difference between the shocks identified from the VAR and those identified via the narrative method is some error \( \varepsilon_{t} \). This assumption has some testable implications, in particular, \( e_{t}^{RR} \) should be orthogonal to all the lags of all variables included in the VAR. We shall test this in the next section of the paper.

Substituting (6) into (5) we obtain a specification for \( \Delta y_t \) that encompasses the two alternative models.
\[ \Delta y_t = \sum_{j=0}^{M} \gamma_{y,t}^{j} e_{t-j}^{RR} \]

(7) makes clear that the limited information approach adopted by R&R—in which the tax multiplier is estimated from a specification including only the first term in (7)—while carrying the benefit of a direct identification of the tax shocks, bears the cost of omitting several sources of information included in the system approach adopted in a VAR. The relevant question is what are the costs and benefits of the two strategies. To assess this we start by asking under what conditions the two approaches will deliver the same estimate of the tax multiplier.

### 3.1 Evaluating the differences

Comparing (7) with (2) reveals that there are three conditions that need to be satisfied for the two approaches to deliver the same estimates of the impulse response of output to a tax shock \( e_{t}^{RR} \):

1. the tax shocks \( e_{t-j}^{RR} \) must be orthogonal to the noise term \( \varepsilon_{t-j} \) introduced by the VAR

2. the tax shocks \( e_{t-j}^{RR} \) must be orthogonal to all other shocks in the VAR that might influence output growth: \( e_{t-j}^{\theta}, e_{t-j}^{y}, e_{t-j}^{\Delta p}, e_{t-j}^{i} \)

3. the tax shocks \( e_{t-j}^{RR} \) must be orthogonal to \( Z_{t-M+1} \).

Given the specification of the VAR, the first condition can be tested by assessing the orthogonality of the R&R shocks to the information set that is used in the VAR to measure innovations and therefore shocks.

Orthogonality of \( e_{t-j}^{RR} \) to \( e_{t-j}^{\theta}, e_{t-j}^{y}, e_{t-j}^{\Delta p}, e_{t-j}^{i} \) is the identifying assumption in R&R: from an analysis of the extensive discussion in the narrative record of why each \( e_{t-j}^{RR} \) action was taken, R&R conclude that "most actions had a single predominant motivation, and that some of those motivations are unrelated to other factors likely to
have important effects on output growth (and to any other tax responses policymakers may have been making to those factors at around the same time)."

The third condition, however, is unlikely to be satisfied, for the following reason. R&R classify as exogenous those legislated tax changes that "are responses to the state of government debt or to concerns about long-run economic growth". Since the variables that in a fiscal VAR are normally included in Z fully determine the dynamics of debt, the orthogonality of $e_{t-j}^{RR}$ to $Z_{t-M+1}$ does not seem to be satisfied by the R&R identification strategy. To see this, consider the government intertemporal budget constraint

$$d_t = \frac{1 + i_t}{(1 + x_t)} d_{t-1} + \frac{\exp(g_t) - \exp(t_{t-1})}{\exp(y_t)}$$

where $x_t = \Delta p_t + \Delta y_t + \pi_t \Delta y_t$. From (8) it is immediately obvious that the dynamics of the debt is fully determined at any point in time by the dynamics of the variables normally included in the vector Z. Therefore, the orthogonality the "tax shocks" $e_{t-j}^{RR}$ to $Z_{t-M+1}$ is violated if government receipts and expenditures respond to the level of debt.5 This consideration remains valid also when the debt-deficit relation is linearized and the debt feedback in the fiscal reaction function is captured by the distributed lags of macroeconomic variables in the VAR.

4 Reconciling the differences

We bring to the data the general encompassing framework proposed in the previous section by adopting the following empirical specification:

5Debt and the intertemporal government budget constraint are always omitted from empirical investigations of the effects of fiscal shocks—not only by R&R, but essentially by the entire empirical literature. This omission is inconsistent with the empirical evidence in Bohn (1998, 2008). If fiscal variables respond to the level of the debt, the analysis of the impact of fiscal shocks should be conducted by explicitly recognizing a role for debt and the stock-flow identity linking debt and deficits, since the response of the economy to fiscal shocks will depend on the dynamic impact on the debt of such shocks. One justification for omitting debt is that the effects of this variable are captured by all other variables included (linearly) in a fiscal VAR. The debt dynamics equation however, is non-linear. Whether or not including debt directly in the VAR makes a difference thus depends on how good an approximation the linear version of (8) is. Only recently Chung and Leeper (2007) have analyzed an empirical model that explicitly considers the government intertemporal budget constraint via cross-equation restrictions derived from a log-linearized version of (8).
\[ Z_t = \sum_{i=1}^{k} C_i Z_{t-i} + \delta e_t^{RR} + \gamma (d_{t-1} - d^*) + u_t \]  

\[ d_t = \frac{1 + i_t}{(1 + \Delta p_t)(1 + \Delta y_t)} d_{t-1} + \frac{\exp(g_t) - \exp(t_t)}{\exp(y_t)} \]

\[ Z'_t = \begin{bmatrix} i_t & y_t & \Delta p_t & t_t & g_t \end{bmatrix} \]

where \( Z_t \) includes the five variables present in a fiscal VAR. We explicitly introduce debt in the VAR. However, to allow for direct comparison with traditional fiscal VARs we shall report two sets of results: those obtained by imposing \( \gamma = 0 \) and those obtained by relaxing this assumption.

The advantage of (9) is that this specification allows us to address all points discussed in the previous section.

We reinterpret the narrative shocks \( e_t^{RR} \) as observed structural shocks to one of the variables included in the fiscal VAR, namely \( t_t \). The validity of the assumption \( e_t = e_t^{RR} + \varepsilon_t \) can be directly checked by assessing the orthogonality of \( e_t^{RR} \) to the information set used in the VAR. If the hypothesis \( e_t^{RR} \perp Z_{t-i} \) is not rejected, then \( e_t^{RR} \) can be considered as observable structural shocks to \( t_t \).

For \( \gamma = 0 \), impulse responses to \( e_t^{RR} \) are obtained in a full-information framework whose underlying MA representation is infinite and not truncated as in R&R. For \( \gamma \neq 0 \) we extend the fiscal VAR framework explicitly allowing for a response of all variables in the VAR to the distance of the debt-to-GDP ratio from a target level \( d^* \). Such debt-feedback mirrors that estimated in Bohn (1998). As in Bohn we take 0.35, as the target value for \( d^* \). As shown in Figure A1, this is also the average debt level in our sample. As we introduce the debt level into the VAR, we need to make it endogenous, otherwise impulse response functions would be computed assuming a constant debt ratio, thus ruling out the very reason why debt is included in the first place—namely to allow macro variables to respond to the effect of the fiscal shock on the level of the debt. The way to make the debt ratio endogenous is to add to the model the equation that describes how it evolves over time as a function of the path of all other variables, i.e. the government’s intertemporal budget constraint (IGBC).

Note that the introduction of the IGBC makes (9) non-linear: constructing an MA representation of \( Z_t \) is thus no longer possible. However, the computation of

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\[ \text{Note that the budget constraint is an identity: it does not add new parameters to be estimated, nor new shocks to be identified.} \]
impulse responses is still possible by going through the following steps:

1. generate a baseline simulation for all variables by solving (9) dynamically forward (this requires setting to zero all shocks for a number of periods equal to the horizon up to which impulse responses are needed),

2. generate an alternative simulation for all variables by setting to one—just for the first period of the simulation—the structural shock of interest, and then solve dynamically forward the model up to the same horizon used in the baseline simulation,

3. compute impulse responses to the structural shocks as the difference between the simulated values in the two steps above. (Note that these steps, if applied to a standard VAR, would produce standard impulse responses. In our case they produce impulse responses that allow for both the feedback from $d_{t-i}$ to $Z_t$ and for the endogeneity of $d_t$ modelled via (8),

4. compute confidence intervals via bootstrap methods.\textsuperscript{7}

\subsection{4.1 Empirical evidence}

\subsubsection{4.1.1 Orthogonality of $e_{t}^{RR}$ to $Z_{t-i}$.}

The regression of $e_{t}^{RR}$ on lags one to four of all variables included in the Blanchard-Perotti VAR for the full sample delivers a negative adjusted $R^2$ of -0.03; the F-test on the joint significance of all regressors takes a value of 0.71 with an associated probability level of 0.84. Clearly the null of orthogonality cannot be rejected. The point is visually illustrated in Figure 3 where we report the R&R shocks, $e_{t}^{RR}$, along with the residuals of the regression of $e_{t}^{RR}$ on $Z_{t-i}$. The two series are nearly perfectly correlated with the only difference being some noise that is added by the regression in all periods when $e_{t}^{RR}$ takes a value of zero (absence of shocks identified by the narrative method). This statistical evidence speaks clearly in favour of treating the R&R shocks as structural shocks in a fiscal VAR and also speaks clearly against considering the residuals from the regression of $e_{t}^{RR}$ to $Z_{t-i}$ as structural shocks.

\textsuperscript{7}Bootstrapping requires saving the residuals from the estimated VAR and then iterating the following steps: a) re-sample from the saved residuals and generate a set of observation for $Y_t$ and $d_t$, b) estimate the VAR and identify structural shocks, c) compute impulse responses going thorough the steps described in the text, d) go back to step 1. By going thorough 1,000 iterations we produce bootstrapped distributions for impulse responses and compute confidence intervals.
4.1.2 Estimating the tax-multiplier

If the assumption $e_t^{RR} \perp Z_{t-i}$ is satisfied, then including $e_t^{RR}$ in the VAR—as done in (9)—is very natural. In fact, the VAR contains an equation describing the endogenous evolution of the tax changes, the equation for $t_t$, and there is no need of identifying the exogenous tax shocks from the VAR residuals, as these shocks have been already identified using information from outside the VAR. Figure 3 clearly shows that obtaining tax shocks from the residuals of the regression of $e_t^{RR}$ to $Z_{t-i}$ does not make justice to the careful and thorough narrative identification of the tax shocks performed by R&R. In fact, the only result obtained by this regression is to contaminate the tax shocks with some spurious noise on the occasion of all the data points where the narrative method identifies no shock.

R&R do not make justice to themselves when they assess the robustness of the fiscal multipliers obtained from (2). Their robustness check implies considering the impulse responses to shocks to exogenous tax changes identified with a two-variable vector autoregression with log-output and the exogenous tax changes. Shocks to exogenous tax changes are identified as the residuals from the regression of $e_t^{RR}$ on twelve lags of each of the two variables included in the VAR. We report in Figure 4 $e_t^{RR}$ and the residuals from the R&R bivariate VAR. Figure 4 resembles Figure 3 very closely. This fact has two important consequences. First, the shocks generated by the bi-variate VAR are a noisy measure of the tax shocks, second the impulse responses generated from the VAR are virtually equivalent to the those in the truncated MA representation (given that $e_t^{RR}$ and the residuals of the regression of this variable on its own lags and the lags of log output are virtually identical) and therefore the robustness analysis conducted within the two-variables VAR model is not a useful benchmark against which assess the original empirical evidence. We claim that a more useful benchmark is obtained by introducing the shocks identified outside the VAR into the relevant VAR as in (9).

The first important evidence that emerges from the estimation of (9) is that the coefficient on $e_t^{RR}$ is not statistically different from zero only in the equation for $t_t$.

The tax multipliers obtained from the estimation of (9) are illustrated in Figures 5 and 6. Figure 5 compares the effect on output of an $e_t^{RR}$ tax shock equivalent to one per cent of U.S. GDP estimated using, alternatively, (2), model (9) without the IGBC ($\gamma_i = 0$), and model (9) with the IGBC. Estimating the effect of R&R tax shocks using the VAR rather than a single equation framework delivers a response of output that is much smaller than that reported by R&R and very similar to that delivered by traditional fiscal VAR and reported in Figure 1. The impact of a tax
shock on output growth estimated in a VAR never exceeds one per cent. The VAR also highlights the instability of the effects of tax shocks between the periods preceding and following 1980: the impact of tax shocks in the first sub-sample is larger and significantly different from the impact in the second sub-sample, where it is not significantly different from zero.

The results in Figure 5 show that the differences between the impulse responses obtained from the estimation of a single equation and those obtained within a system framework only appear after a few quarters, and not on impact. This is a clear symptom that the single-equation framework fails to capture some significant simultaneity.

4.1.3 Debt and the non-linear debt dynamics

Note that the model augmented with debt and the non-linear debt dynamics equation produces results which are very similar to those obtained by including the R&R shocks in a traditional fiscal VAR. Figure 5 confirms that when the R&R measure of tax shocks is considered within a multiple equation model, rather than in a single equation framework, the estimated multipliers are much smaller: while simultaneity is important, we find no major empirical difference between a non-linear model with an explicit debt dynamics equation and a linearized model where the effect of debt is captured by its components. However, despite the fact that non-linearities are not significant over our sample of U.S. data, the non-linear specification might become of crucial importance for analyzing cases in which the debt to GDP ratio is very persistent and large fiscal shocks happen.

4.1.4 Augmenting the R&R regression with further lags of $Z_t$

Figure 6 completes our evidence by reporting the results obtained when re-running the R&R regression augmented it with $Z_{t-M+1}$

$$\Delta y_t = a + \sum_{i=0}^{M} b_i e_{t-i}^{RR} + C_{i+1}^{M+1} Z_{t-M+1} + e_t$$  \hspace{1cm} (10)

This is a robustness check R&R do not perform, since the one they report only uses information dated up to time $M$. Figure 6 reports the effect of tax shocks as originally computed by R&R along with those based on the augmented regression (10) over the full sample 1950:1-2006:2. The Figure shows that the truncation has an effect on the size of the multiplier after the 8th quarter. The multiplier estimated using the
augmented equation is very close \(^8\) to the one delivered by the inclusion of the R&R shocks in a fiscal VAR. Interestingly, the \(R^2\) increases from 0.09 in the original R&R specification to 0.17 in the augmented specification.

5 VAR, the Narrative Identification and Fiscal Foresight

Using the narrative record to identify tax shocks does not require the inversion of the moving average representation of a VAR. In this section we illustrate that the method used in this paper of coupling a VAR specification with the identification of structural fiscal shocks independent from the VAR is particularly advantageous in presence of fiscal foresight. Structural VAR shocks and narrative shocks are different instruments for the true underlying unobservable tax shocks. The main difference in the instruments arises from the fact that the narrative shocks are derived independently from any statistical model. Instead the VAR-based evidence is obviously model dependent and its validity relies on the assumption that the agents’ and the econometrician’s information sets are aligned. Leeper et al (2008) point out that fiscal foresight could cause a misalignment of the two information sets, thus making it impossible to extract meaningful shocks to taxes from statistical innovation in the VAR.

Fiscal foresight happens when agents, at some point in time, receive signals on the taxes they will face in the future. This is very likely given legislative and implementation lags in tax policy. To understand the implication of fiscal foresight consider, as an example, the simplest RBC model, adapted from Leeper et al (2008). The model is log-linearized, with log preferences, inelastic labour supply and complete depreciation of capital. A proportional tax is levied against income and used for lump-sum transfers on a period by period basis. There is no government spending. The economy is subject to two shocks: an exogenous technological shocks \(e^A_t\) and a tax shock, \(e^T_{t+p}\). The tax shock features an implementation lag of \(p\) periods, i.e. news about future tax rates arrive \(p\) periods before the new rates are implemented.

The equilibrium conditions are the following:

\(^8\)The small remaining difference between the impulse responses can be rationalized by the additive noise that drives a wedge between the VAR shocks and the R&R shocks.
\[ \frac{1}{C_t} = \alpha\beta E_t (1 - \tau_{t+1}) \frac{1}{C_{t+1}} \frac{Y_{t+1}}{K_t} \]

\[ C_t + K_t = Y_t = A_t^\alpha \]

\[ \tau_t = \tau \exp (e_{t-p,t}^\tau) \]

\[ A_t = \exp (e_t^A) \]

This reduces (after log-linearization) to a bivariate model for capital and technology

\[ \theta E_t k_{t+1} - (1 + \alpha \theta) k_t + \alpha k_{t-1} = \rho E_t \tau_{t+1} - e_{A,t} \]

\[ \theta = \alpha\beta (1 - \tau), \quad \rho = \frac{1 - \theta}{1 - \tau} \]

After solving the model we obtain the following representation:

\[ k_t = \alpha k_{t-1} + e_t^A - \rho \sum_{i=0}^{\infty} \theta^i E_t e_{t+1+i-p,t+1+i} \]

\[ a_t = e_t^A \]

Consider now estimating a bivariate VAR in \( a_t, k_t \) and retrieving the two shocks from the VAR innovations. As the equilibrium looks different for different degrees of fiscal foresight, the outcome of this procedure would clearly be affected by it.

- In the case of no fiscal foresight the \((q = 0)\) the equilibrium is

\[ k_t = \alpha k_{t-1} + e_t^A \]

\[ a_t = e_t^A \]

and a VAR in \( a_t, k_t \) would feature stochastic singularity, as only one shock will drive the two variables.

- In the case of one-period fiscal foresight, \( q = 1 \), the equilibrium is

\[ a_t = e_t^A \]

\[ k_t = \alpha k_{t-1} + e_t^A - \rho e_{t,t+1}^\tau \]

and a Choleski identification for the innovations in the VAR in \( a_t, k_t \) would allow to correctly identify the structural shocks of interest.
• In the case of two-periods fiscal foresight, \( q = 2 \), the equilibrium is

\[
a_t = e^A_t  \\
k_t = \alpha k_{t-1} + e^A_t - \rho(e^A_{t-1,t+1} + \theta e^A_{t,t+2})
\]

and it would not be possible to identify the structural shocks of interest from the VAR innovations. In fact, for any \( q \geq 2 \) we have non-invertibility of the moving average component of the time series of \( k_t \) (see Hansen and Sargent, 1991, Lippi and Reichlin, 1994).

Note that in the presence of fiscal foresight, the VAR identification is hopeless, while the narrative approach is still able to identify tax shocks, as \( e^A_t \) is constructed independently from the VAR and the estimation of a VAR augmented directly with the relevant combination of tax shocks is clearly feasible. Moreover, the narrative approach naturally delivers a classification of tax shocks into anticipated and unanticipated, where the relevant information set to identify anticipations is clearly larger than that normally considered in a fiscal VAR. To show how the narrative shocks can be included in a fiscal VAR to deal separately with the effects of unanticipated and anticipated fiscal policy we take from Mertens and Ravn (2008) \(^9\) the classification of the R&R shocks into anticipated and unanticipated. Mertens and Ravn consider the following decomposition of the R&R shocks

\[
e^{RR}_t = \tau^u_t + \tau^a_{t,0}
\]

where \( \tau^u_t \) are the unanticipated tax shocks occurring at time \( t \) while \( \tau^a_{t,0} \) are tax shocks that are implemented at time \( t \), having been legislated and therefore announced at a date earlier than \( t \). The notation is different from that of our simple illustrative model to reflect the fact that the implementation lag is not fixed. In the data the difference between announcement and implementation dates features a twin peaked distribution with the peaks occurring at 0-30 days and more than 151 days; the median implementation lag is six quarters. Mertens and Ravn (2008) define a tax change as anticipated if the implementation lags exceeds 90 days (1-quarter). To address the anticipation effect of tax shocks a series of new variables is constructed, \( \tau^a_{t,i} \), that measures the sum of all anticipated tax changes known at date \( t \) to be implemented at date \( t+i \).

The taxonomy of the R&R shocks introduced by Mertens and Ravn makes clear that the tax multipliers derived by interpreting \( e^{RR}_t \) as unanticipated tax shocks do

\(^9\) We are grateful to the two authors for having provided us with their dataset.
not make justice to the existence of implementation lags. However, the idea of using
the narrative shocks identified independently from a VAR within the VAR is still
applicable. In fact, the output effects of anticipated and unanticipated U.S. tax
policy shocks can be derived by estimating the following system that includes in an
appropriate way all different tax shocks\textsuperscript{10}:

\begin{equation}
t_t = \sum_{i=1}^{k} C_{1i} z_{2t-i} + \sum_{i=1}^{k} C_{2i} t_{t-i} + \delta_{11} \tau_{t}^{\mu} + \delta_{12} \tau_{t,0}^{\alpha} + u_{1t} \tag{11}
\end{equation}

\begin{equation}
Z_{2t} = \sum_{i=1}^{k} C_{2i} z_{2t-i} + \delta_{21} \tau_{t}^{\mu} + \delta_{22} \tau_{t,0}^{\alpha} + \sum_{i=1}^{6} G_{2i} \tau_{t-i}^{\alpha} + u_{2t}
\end{equation}

\begin{equation*}
Z'_{2t} = \begin{bmatrix}
i_t & y_t & \Delta p_t & g_t
\end{bmatrix}
\end{equation*}

Note that in (11) tax shocks implemented at time \( t \) enter the equation for (log)
government revenue \( t_t \) with a different coefficient according to their status of unan-
ticipated or anticipated. Tax shocks announced at time \( t \) to be implemented in the
future do not enter this equation. However, tax shocks announced at time \( t \) to be
implemented with all implementation lags up to six quarters are allowed to affect all
other variables included in a fiscal VAR.

The specification generates different impulse responses for anticipated and unan-
ticipated tax shocks. We report in Figure 7 two tax multipliers. The first one is
associated with an unanticipated tax shocks at time \( t \), while the second one describes
the effects on output of a tax shocks announced at time \( t \) with an implementation
lag of six periods. Note that the output effect of the unanticipated tax shocks is
very similar to that of the R&R shocks with a long-run multiplier of about one.
Interestingly, as in Mertens and Ravn, the announcement of a positive tax shock has
a positive impact on output before the implementation, that becomes negative only
after the implementation date\textsuperscript{11}.

6 Conclusions

This paper argues in favour of an empirical strategy based on deriving impulse re-
sponses to fiscal shocks by combining a VAR specification with non-VAR based mea-

\textsuperscript{10}In the light of the results of our previous section we only consider the specification without
debt-feedback.

\textsuperscript{11}Blanchard (1981) finds a similar theoretical result analyzing anticipated and unanticipated fiscal
shocks in a model with sticky prices and perfect foresight.
sures of shocks to government revenues. We have shown that shocks identified via
the narrative approach are orthogonal to the relevant information set in traditional
fiscal VARs: therefore they are valid structural shocks in these VARs. We have then
proceeded to estimating the multiplier associated with tax shocks identified via the
narrative method by including them directly in a fiscal VAR. We find a multiplier
of about one. Using the narrative record to identify tax shocks does not require the
inversion of the moving average representation of a VAR for identification. Exploited
this property of narrative shocks—and the classification, proposed by Mertens and
Ravn (2008), of R&R shocks into anticipated and unanticipated—we have estimated
the multipliers associated with unanticipated tax shocks, and anticipated tax shocks:
shocks announced at time $t$ with an implementation lag of six periods. The empirical
evidence shows that the output effect of unanticipated tax shocks in a fiscal VAR is
very similar to that of the R&R shocks. Announced tax shocks, instead, have opposite
effects in the pre-implementation and the post-implementation periods.

We have also estimated the multiplier keeping track of the effect of tax shocks on
the level of the debt-GDP ratio. We have done this allowing for the non-linearity which
arises from the government budget constraint. No significant empirical difference
emerges between a non-linear model with an explicit debt dynamics equation, and a
linearized model where the effect of debt is captured by its components. Despite the
fact that non-linearities do not appear to be important over our sample of U.S. data,
the non-linear specification might become of crucial importance for analyzing cases
in which the debt-to-GDP ratio is very persistent and large fiscal shocks happen.

The methodology we have developed to analyze the impact of tax shocks by keep-
ing track of the non-linear budget constraint, could be used in other settings. For
instance, the discussions on the importance of including capital as a slow-moving vari-
able to capture the relation between productivity shocks and hours worked (see e.g.
Christiano et al, 2005 and Chari et al. 2005) could benefit from an estimation tech-
nique that tracks the dynamics of the capital stock generated by the relevant shocks.
The same applies to open economy models that study, for instance, the effects of a
productivity shock on the current account and that typically omit a feedback from
the stock of external debt to macroeconomic variables.

This approach could also be extended to the analysis of the effects of tax shocks
on debt sustainability, an issue which cannot be addressed in the context of a VAR
that fails to keep track of the debt dynamics.
7 References


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8 Data Appendix

$y_t$ is (the log of) real GDP per capita, $\Delta p_t$ is the log difference of the GDP deflator. Data for the stock of U.S. public debt and for population are from the FRED database (available on the Federal Reserve of St.Louis website, also downloaded on December 7th 2006). Our measure for $g_t$ is (the log of) real per capita primary government expenditure: nominal expenditure is obtained subtracting from total Federal Government Current Expenditure (line 39, NIPA Table 3.2 ) net interest payments at annual rates (obtained as the difference between line 28 and line 13 on the same table). Real per capita expenditure is then obtained by dividing the nominal variable by population times the GDP chain deflator. Our measure for $t_t$ is (the log of) real per capita government receipts at annual rates (the nominal variable is reported on line 36 of the same NIPA Table).

The R&R tax shocks start in 1947, while our data only start in 1950:1 because data for total government spending are available on a consistent basis only from 1950:1. We thus exclude the exogenous shocks that occurred between January 1947 and December 1949.

Our approach requires that the debt-dynamics equation in (9) tracks the path of $d_t$ accurately: we thus need to define the variables in this equation with some care. The source for the different components of the budget deficit and for all macroeconomic variables are the NIPA accounts (available on the Bureau of Economic Analysis website, downloaded on December 7th 2006). The average cost servicing the debt, $i_t$, is obtained by dividing net interest payments by the federal government debt held by the public (FYGFDPUN in the Fred database) at time $t - 1$. The federal government debt held by the public is smaller than the gross federal debt, which is the broadest definition of the U.S. public debt. However, not all gross debt represents past borrowing in the credit markets since a portion of the gross federal debt is held by trust funds—primarily the Social Security Trust Fund, but also other funds: the Trust Fund for Unemployment Insurance, the Highway Trust Fund, the pension fund of federal employees, etc. The assets held by these funds consist of non-marketable debt. We thus exclude it from our definition of federal public debt. We are unable to build the debt series back to 1947:1, the start of the Romer and Romer sample, because, as mentioned above, data for total government spending, needed to build the debt series, are available on a consistent basis only from 1950:1. 

\textsuperscript{12}Cashell (2006) notes that "this debt exists only as a book-keeping entry, and does not reflect past borrowing in credit markets."
Figure A-1 reports, starting in 1970:1 (the first quarter for which the debt data are available in FRED), this measure of the debt held by the public as a fraction of GDP (this is the dotted line). We have checked the accuracy of the debt dynamics equation in (9) simulating it forward from 1970:1 (this is the continuous line in Figure A-1). The simulated series is virtually super-imposed to the actual one: the small differences are due to approximation errors in computing inflation and growth rates as logarithmic differences, and to the fact that the simulated series are obtained by using seasonally adjusted measures of expenditures and revenues. Based on this evidence we have used the debt dynamics equation to extend $d_t$ back to 1950:1.
Figure A1: Actual (DY) and simulated (DY_I) (dynamically backward and forward starting in 1970:1) debt-GDP ratio. Actual data are observed at quarterly frequency from 1970 onwards and at annual frequency from 1970 backward. The simulated data are constructed using the government intertemporal budget constraint (2) with observed data and initial conditions given by the debt-to-GDP ratio in 1970:1.
Figure 1: Different estimates of structural tax shocks in the narrative and the SVAR approaches

Figure 2: Different estimates of structural tax shocks in the narrative and the VAR approaches
Figure 3: R&R shocks and Residuals from the regression of R&R shocks on $Z_{t-i}$. 

Adjusted R Squared -0.02
F-Stat 0.76 (0.75)
Residuals from the regression of R&R shocks on its own lags and the lags of log output.

Figure 4. Assessing the R&R robustness check
Figure 5: Estimated Impact of an Exogenous Tax Increase of 1% of GDP on GDP with the R&R framework and with the Fiscal VAR framework, with and without the IGBC
Figure 6: Different Shocks, Same Models, Same Impulse Responses
Figure 7: The output effects of unanticipated and anticipated (announced at time $t$ for time $t+6$) positive tax shocks