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Measuring the Output Responses to Fiscal Policy[†]

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A key issue in current research and policy is the size of fiscal multipliers when the economy is in recession. We provide three insights. First, using regime-switching models, we find large differences in the size of spending multipliers in recessions and expansions with fiscal policy being considerably more effective in recessions than in expansions. Second, we estimate multipliers for more disaggregate spending variables which behave differently relative to aggregate fiscal policy shocks, with military spending having the largest multiplier. Third, we show that controlling for predictable components of fiscal shocks tends to increase the size of the multipliers in recessions. (*JEL* C32, E62, H20, H62, H63)

The impact of fiscal policy on output and its components has long been a central part of fiscal policy analysis. But, as has been made clear by the recent debate over the likely effects and desired composition of fiscal stimulus in the United States and abroad, there remains an enormous range of views over the strength of fiscal policy's macroeconomic effects, the channels through which these effects are transmitted, and the variations in these effects and channels with respect to economic conditions. In particular, the central issue is the size of fiscal multipliers when the economy is in recession.

The gist of the recent literature on this issue has effectively been to echo earlier Keynesian arguments that government spending is likely to have larger expansionary effects in recessions than in expansions. Intuitively, when the economy has slack, expansionary government spending shocks are less likely to crowd out private consumption or investment. To the extent discretionary fiscal policy is heavily used in recessions to stimulate aggregate demand, the key empirical question is how the effects of fiscal shocks vary over the business cycle. The answer to this question is not only interesting to policymakers in designing stabilization strategies but it can also help the economics profession to reconcile conflicting predictions about the effects of fiscal shocks across different types of macroeconomic models.

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Despite these important theoretical insights and strong demand by the policy process for estimates of fiscal multipliers, there is little[1] empirical research trying to assess how the size of fiscal multipliers varies over the business cycle. In part, this dearth of evidence reflects the fact that much of empirical research in this area is based on linear structural vector autoregressions (SVARs) or linearized dynamic stochastic general equilibrium (DSGE) models which by construction rule out state-dependent multipliers.[2] The limitations of these two approaches became evident during the recent policy debate in the United States, when government economists relied on neither of these approaches, but rather on more traditional large-scale macroeconometric models, to estimate the effects of US fiscal policy interventions being undertaken then (e.g., Romer and Bernstein 2009, Congressional Budget Office 2009). This reliance on a more traditional approach, in turn, led to criticisms based on conflicting predictions which used SVAR and DSGE approaches (e.g., Barro and Redlick 2009; Cogan et al. 2010; Leeper, Walker, and Yang 2010). A main objective of this paper is to explore this gray area and to provide estimates of state-dependent fiscal multipliers.

Our starting point is the classic paper by Blanchard and Perotti (2002), which estimated multipliers for government purchases and taxes on quarterly US data with the identifying assumptions that (i) discretionary policy does not respond to output within a quarter; (ii) nondiscretionary policy responses to output are consistent with auxiliary estimates of fiscal output elasticities; (iii) innovations in fiscal variables not predicted within the VAR constitute unexpected fiscal policy innovations; and (iv) fiscal multipliers do not vary over the business cycle. These multipliers are still commonly cited, although subsequent research has questioned whether the innovations in these SVARs really represent unanticipated changes in fiscal policy, the challenge relating both to expectations and to whether the changes in fiscal variables, notably taxes, represent actual changes in policy, rather than other changes in the relationship between fiscal variables and the included SVAR variables.

Building on Blanchard and Perotti (2002) and the subsequent studies, our paper extends the existing literature in three ways. First, using regime-switching SVAR models, we estimate effects of fiscal policies that can vary over the business cycle.[3] We find large differences in the size of spending multipliers in recessions and expansions with fiscal policy being considerably more effective

[1] We are aware only of Tagkalakis (2008), who uses annual data for a panel of OECD economies to study the effects of fiscal policy on consumption in expansions and recessions.

[2] Alternative identification approaches, notably the narrative approach of Ramey and Shapiro (1998) and Romer and Romer (2010), rely instead on published information about the nature of fiscal changes. But while the narrative approach offers a potentially more convincing method of identification, it imposes a severe constraint on its own, that the effects of only a very specific class of shocks can be evaluated (respectively, military spending build-ups and tax changes unrelated to short-term considerations such as recession or the need to balance spending changes). Furthermore, the narrative approach tends to provide qualitative assessments of the effects of fiscal policy shocks while policymakers are most interested in quantitative estimates of the effects. Romer and Romer (2010) and Ramey (2011) are recent exceptions that provide quantitative estimates of fiscal multipliers.

[3] We prefer introducing regime switches in a SVAR rather than in a DSGE model since it is difficult to model slack in the economy and potentially non-clearing markets in a DSGE framework without imposing strong assumptions regarding the behavior of households and firms. In contrast, SVAR models require fewer identifying assumptions and thus are tied more easily to empirical reality.

in recessions than in expansions. Second, to measure the effects for a broader range of policies, we estimate multipliers for more disaggregate spending variables, which often behave quite differently in relation to aggregate fiscal policy shocks. Third, we provide a more precise measure of unanticipated shocks to fiscal policy. Specifically, we have collected and converted into electronic form the quarterly forecasts of fiscal and aggregate variables from the University of Michigan's RSQE macroeconometric model. We also use information from the Survey of Professional Forecasters (SPF) and the forecasts prepared by the staff of the Federal Reserve Board (FRB) for the meetings of the Federal Open Market Committee (FOMC). We include these forecasts in the SVAR to purge fiscal variables of "innovations" that were predicted by professional forecasters. We find that the forecasts help explain a considerable share of the fiscal innovations, and that controlling for this predictability increases the size of estimated multipliers in recession.

The next section of the paper lays out the basic specification of our regime-switching model. Section II presents basic results for this model for aggregate spending. Section III provides results for individual components of spending and Section IV develops and presents results for our method of controlling for expectations. Section V concludes.

I. Econometric Specification

To allow for responses differentiated across recessions and expansions, we employ a regime switching vector autoregression model where transitions across states (i.e., recession and expansion) are smooth. Our estimation approach, which we will call STVAR, is similar to smooth transition autoregressive (STAR) models developed in Granger and Teravistra (1993). One important difference between STAR and our STVAR, however, is that we allow not only differential dynamic responses but also differential contemporaneous responses to structural shocks.

The key advantage of STVAR relative to estimating SVARs for each regime separately is that with the latter we may have relatively few observations in a particular regime—especially for recessions—which makes estimates unstable and imprecise. In contrast, STVAR effectively utilizes more information by exploiting variation in the degree (which sometimes can be interpreted as the probability) of being in a particular regime so that estimation and inference for each regime is based on a larger set of observations. Note that, to the extent we estimate properties of a given regime using in part dynamics of the system in another regime, we bias our estimates towards not finding differential fiscal multipliers across regimes.[4]

[4] Pereira and Lopes (2010) employ an alternative approach based on estimating a VAR with time-varying coefficients (TVCs), where VAR coefficients are assumed to follow uncorrelated random walks, and estimation is done by Bayesian methods. The variation of coefficients over the business cycle in Pereira and Lopes (2010) is small most likely because (i) Bayesian methods tend to smooth the path of TVCs; and (ii) modeling dynamics as uncorrelated random walks leaves the variation in TVC unrelated to the state of the business cycle in any structurally meaningful way. In contrast, we allow for an explicit and systematic variation of the response over the business cycle.

Our basic specification is:

$$\mathbf{X}_t = (1 - F(z_{t-1}))\mathbf{\Pi}_E(L)\mathbf{X}_{t-1} + F(z_{t-1})\mathbf{\Pi}_R(L)\mathbf{X}_{t-1} + \mathbf{u}_t, \tag{1}$$

$$\mathbf{u}_t \sim N(0, \mathbf{\Omega}_t), \tag{2}$$

$$\mathbf{\Omega}_t = \mathbf{\Omega}_E(1 - F(z_{t-1})) + \mathbf{\Omega}_R F(z_{t-1}), \tag{3}$$

$$F(z_t) = \frac{\exp(-\gamma z_t)}{1 + \exp(-\gamma z_t)}, \quad \gamma > 0, \tag{4}$$

$$\text{var}(z_t) = 1, \; E(z_t) = 0. \tag{5}$$

As in Blanchard and Perotti (2002), we estimate the equation using quarterly data and set $\mathbf{X}_t = [G_t \; T_t \; Y_t]'$ in the basic specification where G is log real government (federal, state, and local) purchases (consumption and investment),[5] T is log real government receipts of direct and indirect taxes net of transfers to businesses and individuals, and Y is log real gross domestic product (GDP) in chained 2000 dollars.[6,7] This ordering of variables in $\mathbf{X}_t$ means that shocks in tax revenues and output have no contemporaneous effect on government spending. As argued in Blanchard and Perotti (2002), this identifying minimum-delay assumption may be a sensible description of how government spending operates because in the short run government may be unable to adjust its spending in response to changes in fiscal and macroeconomic conditions.[8]

The model allows two ways for differences in the propagation of structural shocks: a) contemporaneous via differences in covariance matrices for disturbances $\mathbf{\Omega}_R$ and $\mathbf{\Omega}_E$; b) dynamic via differences in lag polynomials $\mathbf{\Pi}_R(L)$ and $\mathbf{\Pi}_E(L)$. Variable z is an index (normalized to have unit variance so that γ is scale invariant) of the business cycle, with positive z indicating an expansion. Adopting the convention that $\gamma > 0$, we interpret $\mathbf{\Omega}_R$ and $\mathbf{\Pi}_R(L)$ as describing the behavior of the system in a (sufficiently) deep recession (i.e., $F(z_t) \approx 1$) and $\mathbf{\Omega}_E$ and $\mathbf{\Pi}_E(L)$ as describing the behavior of the system in a (sufficiently) strong expansion (i.e., $1 - F(z_t) \approx 1$). We date the index z by $t - 1$ to avoid contemporaneous feedbacks from policy actions into whether the economy is in a recession or an expansion.

The choice of index z is not trivial because there is no clear-cut theoretical prescription for what this variable should be. We set z equal to a seven-quarter moving

[5] We use the traditional approach of defining G to include direct consumption and investment purchases, which excludes the imputed rent on government capital stocks. While the current US method of constructing the national accounts now includes imputed rent, this was not the case for most of our sample period. Although the historical national accounts have been revised to conform to the new approach, we cannot do this for our series of professional forecasts. Therefore, we utilize the traditional method of measuring G in order to have series that are consistent over time.

[6] To compute G and T, we apply the GDP deflator to nominal counterparts of G and T. We estimate the equations in log levels in order to preserve the cointegrating relationships among the variables. An alternative but more complex approach would be to estimate the equations in differences and include error correction terms.

[7] We find similar results when we augment this VAR with variables capturing the stance of monetary policy.

[8] In principle, identification can be further strengthened by using sign restrictions. However, given the complexity of the model and our interest in point estimates rather than ranges, we leave this alternative for future research.

average of the output growth rate. The key advantages of using this measure of z are: (i) we can use our full sample for estimation, which makes our estimates as precise and robust as possible; (ii) we can easily consider dynamic feedbacks from policy changes to the state of the regime (i.e., we can incorporate the fact that policy shocks can alter the regime).[9]

Although it is possible, in principle, to estimate $\{\mathbf{\Pi}_R(L), \mathbf{\Pi}_E(L), \mathbf{\Omega}_R, \mathbf{\Omega}_E\}$ and γ simultaneously, identification of γ relies on nonlinear moments and hence estimates may be sensitive to a handful of observations in short samples. Granger and Teravistra (1993) suggest imposing fixed values of γ and then using a grid search over γ to ensure that estimates for $\{\mathbf{\Pi}_R(L), \mathbf{\Pi}_E(L), \mathbf{\Omega}_R, \mathbf{\Omega}_E\}$ are not sensitive to changes in γ. We calibrate $\gamma = 1.5$ so that the economy spends about 20 percent of time in a recessionary regime (that is, $\Pr(F(z_t) > 0.8 = 0.2)$ where we define an economy to be in a recession if $F(z_t) > 0.8$.[10] This calibration is consistent with the duration of recessions in the US according to NBER business cycle dates (21 percent of the time since 1946). Figure 1 compares the dynamics of $F(z_t)$ with recessions identified by the NBER.

Given the highly nonlinear nature of the system described by equations (1)–(5), we use Monte Carlo Markov Chain methods developed in Chernozhukov and Hong (2003) for estimation and inference (see the Appendix for more details). Under standard conditions, this approach finds a global optimum in terms of fit. Furthermore, the parameter estimates as well as their standard errors can be computed directly from the generated chains.

When we construct impulse responses to government spending shocks in a given regime, we initially ignore any feedback from changes in z into the dynamics of macroeconomic variables.[11] In other words, we assume that the system can stay for a long time in a regime. The advantage of this approach is that, once a regime is fixed, the model is linear and hence impulse responses are not functions of history (see Koop, Pesaran, and Potter (1996) for more details). However, we do consider later the effect of incorporating changes in z as part of the impulse response functions, recomputing z consistently with the predicted changes in output.

Most of the impulse response functions and multipliers we present below are for changes in government purchases, G, and its components. While, primarily for the

[9] We also considered, as an alternative, the Stock and Watson (1989) coincident index of the business cycle (now maintained by the Federal Reserve Bank of Chicago and called Chicago Fed National Activity Index). This series dates only to the mid-1960s and cannot be used for endogenous-regime multiplier calculations, but a potential benefit is that it incorporates more information than the growth rate of real GDP. However, our alternative estimates using this index (not shown) suggest that the choice between the two definitions of z does not have a qualitatively important impact on our empirical results. More generally, we chose the (moving average of) the output growth rate over typical measures of the output gap for several reasons. First, there is disagreement about which measure of the gap to use and we did not want our analysis to hinge on this point of contention. Second, it is much easier to compute feedback from policy to state for growth rates than for filtered series corresponding to the output gap (e.g., consider the two-sided lead/lag transforms necessary for computing HP filtered series). Third, the gap tends to lag recessions substantially; that is, the economy can be quickly expanding while the gap is still be large.

[10] When we estimate $\{\mathbf{\Pi}_R(L), \mathbf{\Pi}_E(L), \mathbf{\Omega}_R, \mathbf{\Omega}_E\}$ and γ simultaneously, we find point estimates for γ to be above 5 to 10 depending on the definitions of variables and estimation sample. These large parameter estimates suggest that the model is best described as a model switching regimes sharply at certain thresholds. However, we prefer smooth transitions between regimes (which amounts to considering moderate values of γ) because in some samples we have only a handful of recessions and then parameter estimates for $\{\mathbf{\Pi}_R(L), \mathbf{\Pi}_E(L), \mathbf{\Omega}_R, \mathbf{\Omega}_E\}$ become very imprecise.

[11] Alternatively, one can interpret this approach as ordering z last in the VAR and setting all z to a fixed value.

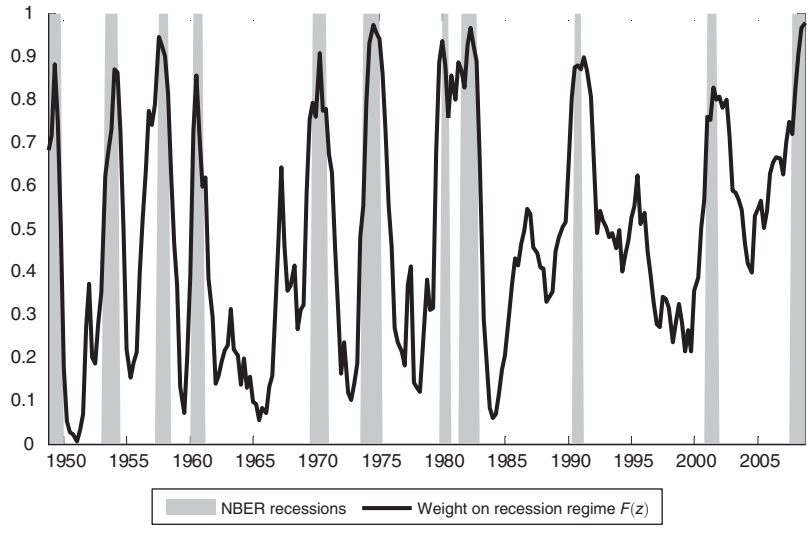

FIGURE 1. NBER DATES AND WEIGHT ON RECESSION REGIME $F(z)$

Notes: The shaded region shows recessions as defined by the NBER. The solid black line shows the weight on recession regime $F(z)$.

purpose of comparison with previous studies, we present some results for changes in taxes in the Appendix (Figure A1), we have several reasons for focusing on G. First, much of the debate in the SVAR and DSGE literatures has been about the effects of government purchases. Second, we are less confident of the SVAR framework as a tool for measuring the effects of tax policy, because (as discussed above) many of the unexpected changes in T may not arise as a result of a policy change, but rather as a result of a change in the relationship between tax revenues and aggregate activity, and because we would expect the effects of tax policy to work through the structure of taxation (e.g., marginal tax rates) rather than simply through the level of tax revenues. Finally, identification of tax shocks depends on our ability to purge innovations in revenues of automatic responses to output and, as discussed in Blanchard and Perotti (2002), the key ingredient here is the elasticity of revenue with respect to output. However, this elasticity is likely to vary over the cycle, thereby introducing a bias of unknown magnitude and direction in our regime-specific estimates. Indeed, we have found that output responses to tax shocks in different regimes are very sensitive to the assumed elasticity.

II. Basic Aggregate Results

We begin by considering the effects of aggregate government purchases in the linear model with no regime shifts or control for expectations, following the basic specification of Blanchard and Perotti (2002), including the same ordering $[G\ T\ Y]$ for the Cholesky decomposition. Our sample period is 1947:I–2008:IV. Figure 2 displays the resulting impulse response functions (IRFs) for a government purchase shock. These multipliers demonstrate by how many dollars output, taxes, and

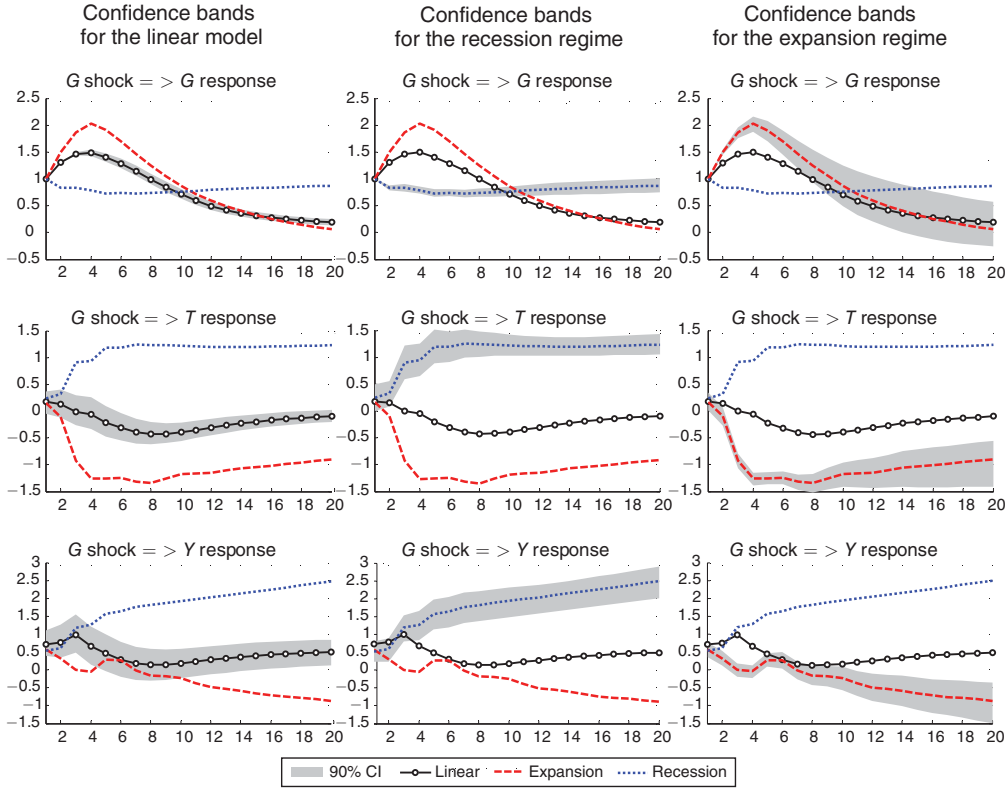

FIGURE 2. IMPULSE RESPONSES IN THE LINEAR MODEL, EXPANSIONS, AND RECESSIONS

Notes: The figures show impulse responses to a $1 increase in government spending. Shaded region is the 90 percent confidence interval. Dashed lines show the responses in expansionary (long dash) and recessionary (short dash) regimes. The solid line with circles shows the response in the linear model.

government purchases increase over time when government purchases are increased by $1.[12] In this and all subsequent figures, the shaded bands around the impulse response functions are 90 percent confidence intervals.[13] Consistent with results reported in previous studies (see, for example, the survey by Hall 2009), the maximum size of the government spending multiplier in the linear VAR model (the first column in Figure 2) is about 1 and this maximum effect of a government spending shock on output is achieved after a short delay. The response of future government purchases also peaks after a short delay, indicating that the typical government spending shock during the sample period is of relatively short duration. Taxes fall slightly in response to the increase in government purchases. This fall in taxes may contribute to the positive impact on output that persists even as the increase in government purchases dies off over time.

[12] Because government purchases and output enter the estimated equations in logs, we scale the estimated IRFs by the sample average values of Y/G to convert percent changes into dollar changes.

[13] The Appendix discusses our method of estimating these confidence intervals.

The second and third columns of Figure 2 plot the corresponding IRFs with associated error bands in recessions and expansions, respectively. Because of the smaller effective number of observations for each regime, particularly for recessions, the confidence bounds are greater for these IRFs than for those for the linear model in the first column of Figure 2. Even with these wide bands, however, the responses in recession and expansion are quite different. In both regimes, the impact output multiplier is about 0.5, slightly below that estimated for the linear model. Over time, though, the IRFs diverge, with the response in expansions never rising higher and soon falling below zero, while the response in recessions rises steadily, reaching a value of over 2.5 after 20 quarters. The strength of this output response in recession is not attributable simply to differences in the permanence of the spending shock or the tax response. Taxes actually rise in recession, while falling in expansion. This difference, which is consistent with the automatic responses of tax collections to changes in output, should weaken the differences in the observed output responses in recession and expansion; and while the government spending shock is more persistent in recession, it is stronger in the short run in expansion.[14]

To put the magnitudes of these multipliers in perspective, consider multipliers in Keynesian models as well as the more recent DSGE literature. Traditional Keynesian (IS-LM-AS) models usually have large multipliers since the size of the multiplier (when accommodating monetary policy keeps the interest rate from rising) is given by $1/(1 - MPC)$ where MPC is the marginal propensity to consume which is typically quite large (about 0.5–0.9).[15] To the extent that the AS curve in the IS-LM-AS model is upward sloping, the multiplier can vary from relatively large (the AS curve is flat and there is a great deal of slack in the economy; i.e., in a recession) to relatively small (the AS curve is steeply upward sloping and the economy operates at full capacity; i.e., in an expansion). In contrast, an increase in government spending in modern business cycle models usually leads to a large crowding out of private consumption in recessions and expansions and correspondingly the typical magnitude for the multiplier is less than 0.5 (in many cases much smaller). Recent findings from DSGE models with some Keynesian features (e.g., Christiano, Eichenbaum, and Rebelo 2011; Eggertsson 2008; and Woodford 2011), however, suggest that the government spending multiplier in periods with a binding zero lower bound (ZLB) on nominal interest rates (which are recessionary times) could be somewhere between 3 and 5. Intuitively, with the binding zero lower bound, increases in government spending have no effect on interest rates and thus there is no crowding out of investment or consumption, which leads to large multipliers. Of course, our estimates are based on several periods of recession and not just the recent episode during which the ZLB became an important issue.

In short, our estimates of the government spending multiplier in recessions and expansions are largely consistent with the theoretical arguments in both (old)

[14] Note that the contemporaneous responses of output to a shock in government spending are similar in recessions and expansions. This result suggests that the differences in the magnitudes of the multipliers across regimes are driven by the differences in the dynamics (i.e., $\{\mathbf{\Pi}_R(L), \mathbf{\Pi}_E(L)\}$) rather than in the covariance of error terms (i.e., $\{\mathbf{\Omega}_R, \mathbf{\Omega}_E\}$).

[15] For example, Shapiro and Slemrod (2003) and Johnson, Parker and Souleles (2006) report that the marginal propensity to consume out of (small) tax rebates in 2001 EGTRRA was somewhere between in 0.5 and 0.7.

TABLE 1—MULTIPLIERS

	$max_{h=1,\ldots,20}\{Y_h\}$		$\sum_{h=1}^{20} Y_h / \sum_{h=1}^{20} G_h$	
	Point estimate	Standard error	Point estimate	Standard error
Total spending				
Linear	1.00	0.32	0.57	0.25
Expansion	0.57	0.12	−0.33	0.20
Recession	2.48	0.28	2.24	0.24
Defense spending				
Linear	1.16	0.52	−0.21	0.27
Expansion	0.80	0.22	−0.43	0.24
Recession	3.56	0.74	1.67	0.72
Nondefense spending				
Linear	1.17	0.19	1.58	0.18
Expansion	1.26	0.14	1.03	0.15
Recession	1.12	0.27	1.09	0.31
Consumption spending				
Linear	1.21	0.27	1.20	0.31
Expansion	0.17	0.13	−0.25	0.10
Recession	2.11	0.54	1.47	0.31
Investment spending				
Linear	2.12	0.68	2.39	0.67
Expansion	3.02	0.25	2.27	0.15
Recession	2.85	0.36	3.42	0.38
Total spending; multipliers for alternative measures of normalized unanticipated shocks to government spending.				
Baseline model, normalized shocks to government spending				
Expansion	0.63	0.13	−0.33	0.20
Recession	3.06	0.35	2.24	0.24
SPF/RSQE forecast errors as contemporaneous shocks (Panel A in Figure 7)				
Expansion	1.13	0.20	−1.23	0.65
Recession	3.85	0.29	2.99	0.27
Control for SPF/Greenbook forecast of government spending (Panel B in Figure 7)				
Expansion	0.82	0.12	0.40	0.15
Recession	3.27	0.73	2.58	0.59
Real-time SPF/Greenbook forecast error for ΔG as an unanticipated shock (Panel C in Figure 7)				
Expansion	0.46	0.27	−0.25	0.23
Recession	7.14	1.45	2.09	1.35
Ramey (2011) news shocks (Panel D in Figure 7)				
Expansion	0.66	0.12	−0.49	0.24
Recession	4.88	0.67	3.76	0.52

Note: The table shows output multipliers for a $1 increase in government spending.

Keynesian and (new) modern business cycle models. Table 1 summarizes these output multipliers for the cases just considered, as well as those that follow. The table presents multipliers measured in two ways. The first column gives the maximum impact on output (with standard errors in the second column) and the third column (with standard errors in the fourth column) shows the ratio of the sum of the Y response (to a shock in G) to the sum of G response (to a shock in G). The first measure of the fiscal multiplier has been widely used since Blanchard and Perotti (2002). The second measure has been advocated by Woodford (2011) and others since the size of the multiplier depends on the persistence of fiscal shocks. Regardless of which way we compute the multiplier, it is much larger in recessions than in expansions.

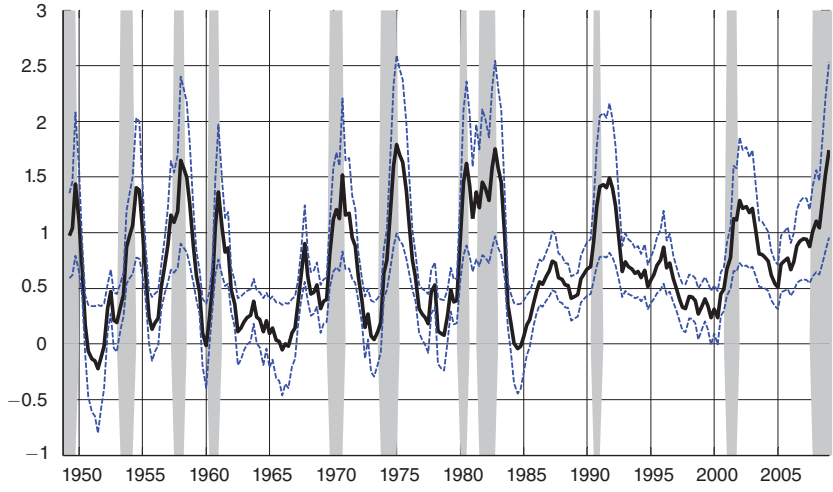

FIGURE 3. HISTORICAL MULTIPLIER FOR TOTAL GOVERNMENT SPENDING

Notes: Shaded regions are recessions defined by the NBER. The solid black line is the cumulative multiplier computed as $\sum_{h=1}^{20} Y_h / \sum_{h=1}^{20} G_h$, where time index h is in quarters. Blue dashed lines are 90 percent confidence interval. The multiplier incorporates the feedback from G shock to the business cycle indicator z. In each instance, the shock is one percent increase in government spending.

The differences between our regime-based multipliers probably are exaggerated by our assumptions that the regimes themselves don't change and that we consider settings corresponding to very strong expansions or recessions. Hence, one should interpret reported magnitudes of the multipliers for the two regimes as bounds from polar settings rather than routinely encountered values. More realistic situations will fall between the extremes. For example, if the multiplier is smaller in expansion than in recession and the economy has a positive probability of shifting from recession to expansion in future periods, then the actual multipliers starting in recession (or expansion) should be a blend of those estimated for the separate regimes. Calculating full dynamic impulse response functions that include internally consistent regime shifts is complicated, because we must compute the index z and evaluate the function $F(z)$ at each date along the trajectory. Also, because the IRFs are now nonlinear, they will depend on the initial value of the index z and the size of the government policy shock. For example, the more deep the initial recession, and the less positive the spending shock, the less important future regime shifts out of recession will be. Therefore, we must specify the initial conditions and the size of the policy experiment in order to estimate the dynamic IRFs.

Figure 3 presents estimates for the historical effects of shocks to government purchases on output, incorporating regime shifts in response to government spending shocks. For each period, we consider a policy shock equal to one percent increase in G and report a dollar increase in output per dollar increase in government spending over 20 quarters (i.e., $\sum_{h=1}^{20} Y_h / \sum_{h=1}^{20} G_h$). The size of the multiplier varies considerably over the business cycle. For example, in 1985, an increase in government spending would have barely increased output. In contrast, a dollar increase

in government spending in 2009 could raise output by about $1.75. Typically, the multiplier is between 0 and 0.5 in expansions and between 1 and 1.5 in recessions. Note the size of the multiplier tends to change relatively quickly as the economy starts to grow after reaching a trough. Thus, the timing of changes in discretionary government spending is critical for effectiveness of countercyclical fiscal policies.

III. Results for Components of Spending

Just as output multipliers for government purchases differ according to the regime in which they occur, they can also differ for different components of government purchases (see Perotti 2007). As discussed earlier, studies using the narrative approach tend to focus on military build-ups, but how useful are these shocks to defense spending in analyzing the effects of other changes in spending policies, such as those adopted during the recent recession?

Figure 4 shows that IRFs for output in response to defense and nondefense spending shocks, based on a four-variable VAR including defense and nondefense purchases, as well as output and taxes. We order the Cholesky decomposition with defense spending first and nondefense spending second, although this does not have an important effect on the results.[16] Clearly, the IRFs have different shapes for the linear model. For a unit shock to defense spending, output rises immediately by just over 1, which is consistent with Ramey (2011), and then gradually falls, becoming negative after several quarters. For nondefense spending, the output effect starts smaller but eventually exceeds 1 and remains above 0.6 for the entire period shown. Once the results are broken down by regime, however, we can see a much stronger dependence on the regime of the defense spending IRFs, which are similar to the linear-model results for the case of expansion but much more positive in recession, peaking at nearly 4 in the fifth quarter after the shock. For nondefense spending, on the other hand, the differences between regimes are primarily with respect to timing rather than size, with the most positive responses occurring rapidly in expansions but with several quarters' delay in recessions.

Figure 5 shows the results of an experiment that breaks government purchases down in a different way, into consumption and investment spending, with consumption ordered first.[17] Once again, the results differ considerably by regime and by spending component. In this decomposition, both components of spending have positive effects on output in the linear model, although the effects of investment spending are much stronger, particularly during the first few quarters when the impact on output exceeds 2 for investment but is around 0.5 for consumption. Estimating the IRFs separately for recession and expansion leads in general to the expected result of more positive multipliers in recession than in expansion. The IRFs are also noisier for the separate regimes, indicating an imprecision of these point estimates that is consistent with the larger confidence intervals (see Appendix figures).

[16] Further details regarding confidence intervals and the effects on taxes and spending components are provided in the Appendix Figures A2–A3.

[17] Appendix Figures A4–A5 provide further details of this experiment.

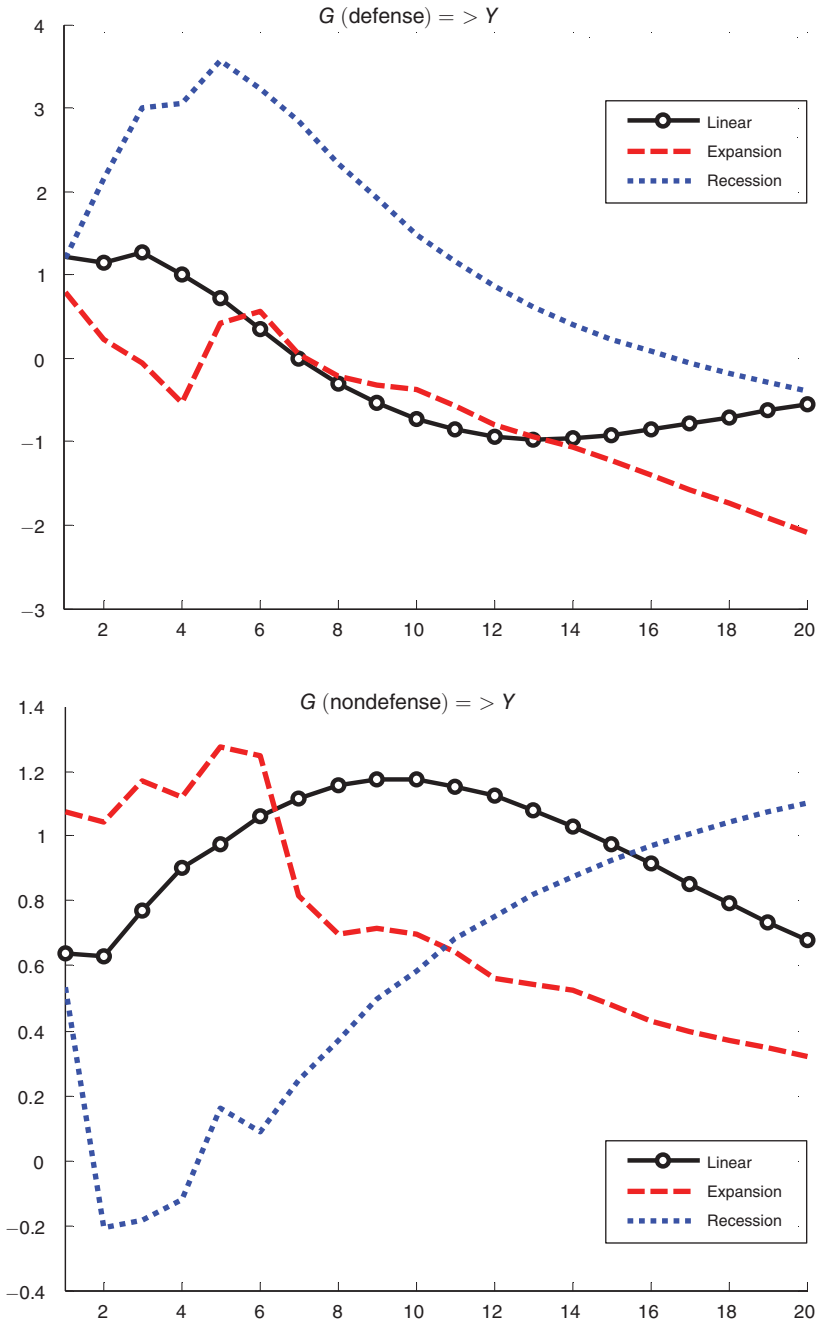

FIGURE 4. DEFENSE AND NONDEFENSE GOVERNMENT SPENDING

Notes: The figures show impulse responses to a $1 increase in government spending: defense spending in the top panel and nondefense spending in the bottom panel. Dashed lines show the responses in expansionary (long dash) and recessionary (short dash) regimes. The solid line with circles shows the response in the linear model.

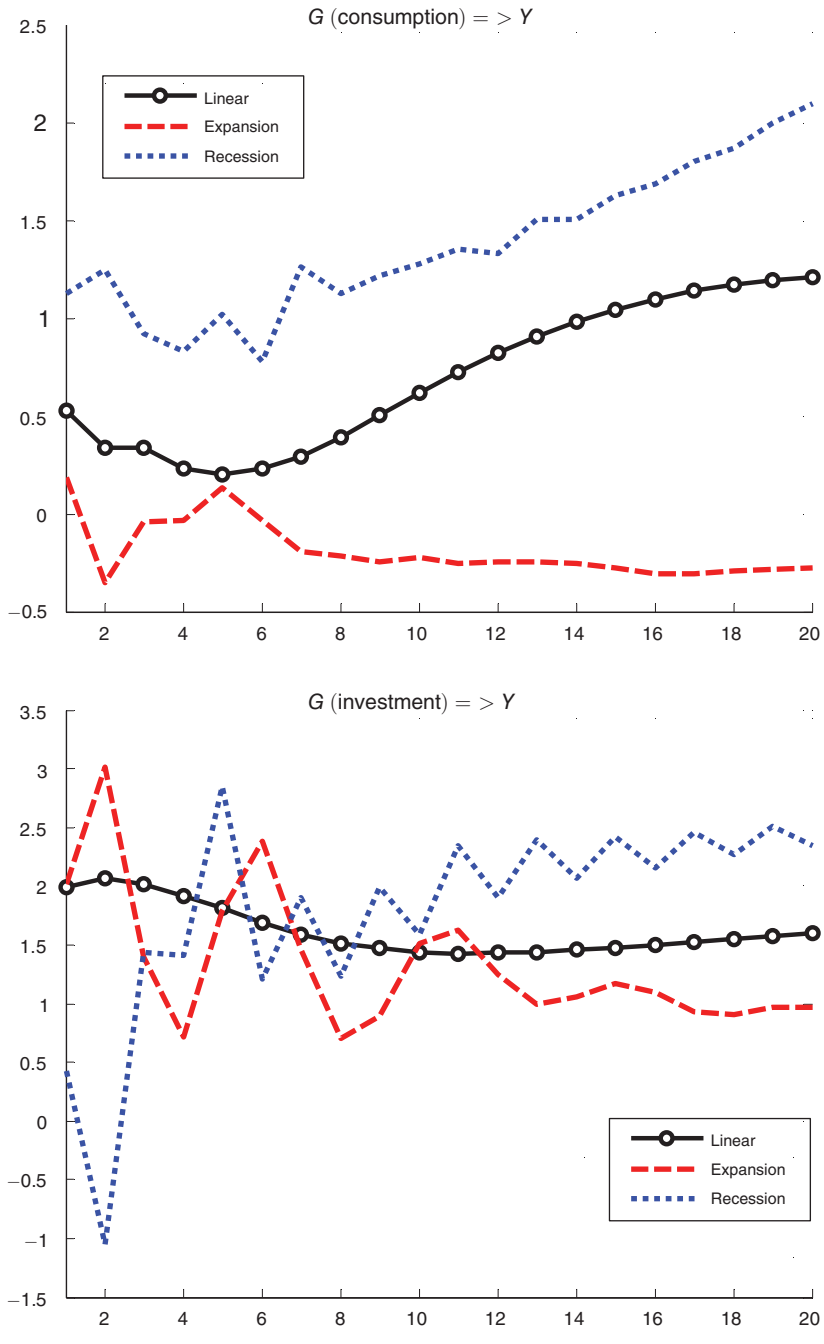

FIGURE 5. CONSUMPTION AND INVESTMENT GOVERNMENT SPENDING

Notes: The figures show impulse responses to a $1 increase in government spending: consumption spending in the top panel and investment spending in the bottom panel. Dashed lines show the responses in expansionary (long dash) and recessionary (short dash) regimes. The solid line with circles shows the response in the linear model.

IV. Controlling for Expectations

As emphasized by Ramey (2011) and others, the timing of fiscal shocks plays a critical role in identifying the effect of fiscal shocks. In the spirit of Ramey (2011), we control for expectations not already absorbed by the VAR using real-time professional forecasts from three sources. First, we draw forecasts for output and government spending variables from the Survey of Professional Forecasters (SPF), an average of forecasts (with the number of individual forecasters ranging from 9 to 50) available since 1968 for GDP and since 1982 for government spending and its components. Second, for government revenues, we use the University of Michigan RSQE econometric model, for which forecasts are available for the period beginning in 1982.[18] Third, we use government spending (Greenbook) forecasts prepared by the FRB staff for FOMC meetings. The Greenbook forecasts for government spending are available from 1966 to 2004. Since the FOMC meets 8 or 12 times a year in our sample, we take Greenbook forecasts prepared for the meeting which is the closest to the middle of the quarter to make it comparable to SPF forecasts. Since the properties of the Greenbook and SPF forecasts are similar, we splice the Greenbook and SPF government spending forecasts and construct a continuous forecast series running from 1966 to present. For each variable, we use the forecast made in period $t-1$ for the period-t value. Because there have been numerous data revisions in the National Income and Product Accounts since the dates of these forecasts, we use forecast growth rates rather than levels.

The importance of controlling for expectations is illustrated in Figure 6, which plots the residuals from projecting forecasted and actual growth rates of government spending on lags of the variables in our baseline VAR.[19] If the VAR innovations were truly unexpected, then these two residuals would be unrelated, but the correlation between forecasted and actual growth rates of government spending (net of the information contained in the VAR lags) is about 0.3–0.4, which points to conclusion that a sizable fraction of VAR innovations is predictable. Therefore, one should be interested in using refined measures of unanticipated shocks to government spending.

The simplest way to account for these forecastable components of VAR residuals is to expand the vector $\mathbf{X}_t$ to include professional forecasts. That is, if we let the SPF/Greenbook/RSQE forecasts made at time $t-1$ for the growth rate of real government purchases for time t be denoted $\Delta G^F_{t|t-1}$ (where $\Delta G^F_{s|t}$ is the growth rate of government spending G at time s forecasted at time t) and define the professional forecasts for output and taxes the same way, we would use the expanded vector in equation (1) $[\Delta G^F_{t|t-1}\, \Delta T^F_{t|t-1}\, \Delta Y^F_{t|t-1}\, G_t\, T_t\, Y_t]'$, stacking the forecasts first because by the timing there is no contemporaneous feedback from unanticipated shocks at time t to forecasts made at time $t-1$.[20] This direct approach is attractive because it

[18] The University of Michigan data are coded from hard copies. Hard copies of forecasts prior to 1982 were lost that year in the fire that destroyed that university's Economics Department building.

[19] The figure presents two versions of this plot, with similar results, one relating forecast residuals to VAR residuals based on real-time data, the other to VAR residuals based on final-vintage data.

[20] See Leduc, Sill, and Stark (2007) for a more detailed discussion on the ordering.

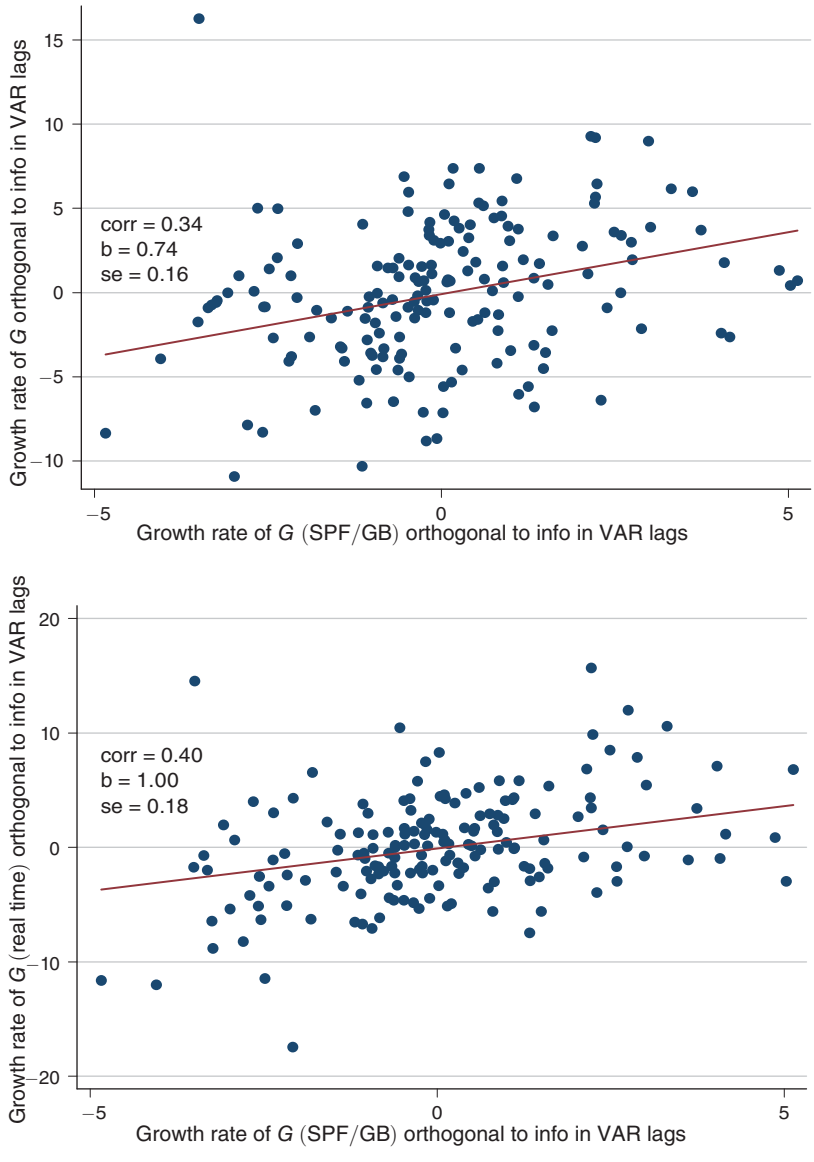

FIGURE 6. FORECASTABILITY OF VAR SHOCKS TO GOVERNMENT SPENDING

Notes: The figure plots residuals from projections of the growth rate of government spending predicted in SPF/Greenbook [horizontal axis] and actual growth rate of government spending (final vintage of data = top panel; real-time/first-release data = bottom panel) [vertical axis] on the information contained in the lags of the our baseline VAR. corr stands for the correlation between series. b and se show the estimated slope and associated standard error from regressing the residual for the actual growth rate of government spending on the residual for the predicted growth rate of government spending.

accounts automatically for any effects that expectations might have on the aggregate variables and for the determinants of the expectations themselves. In practice, however, we have found this approach to be too demanding given our data limitations, for it doubles the number of variables in the VAR while eliminating more than half

of the observations in our sample (i.e., those before 1982); the resulting confidence intervals are very large, particularly for the recession regime for which we have effectively fewer observations.[21,22]

We consider two alternative approaches. The first alternative is a two-step process. The first step of this process is to create "true" innovations by subtracting forecasts of the vector $\mathbf{X}_t$ from $\mathbf{X}_t$ itself. We then fit $\mathbf{\Omega}_t = \mathbf{\Omega}_E(1 - F(z_{t-1})) + \mathbf{\Omega}_R F(z_{t-1})$ (i.e., equation (3)) using these forecast errors (rather than the residuals from the VAR itself). From this step, we use estimated $\mathbf{\Omega}_E$ and $\mathbf{\Omega}_R$ to construct contemporaneous responses to shocks in expansions and recessions. The second step involves using the previously-estimated baseline VAR with regime switches. In this step, we use the estimated coefficients $\mathbf{\Pi}_E(L)$ and $\mathbf{\Pi}_R(L)$ to map the propagation of contemporaneous responses created in the first step. This two-step approach has the advantage of allowing us to base the VAR on our full sample and the original number of variables. Its main disadvantage is that the IRF dynamics will not necessarily be correct, given that the VAR is estimated under the assumption that the innovations to $\mathbf{X}_t$ are fully unanticipated.

The second alternative approach is to augment the baseline VAR directly, but with only one variable, pertaining to the forecast of government spending. For example, the vector of variables in the VAR could be $\tilde{\mathbf{X}}_t = [\Delta G^F_{t|t-1}\, G_t\, T_t\, Y_t]'$ or $\hat{\mathbf{X}}_t = [FE^G_t\, G_t\, T_t\, Y_t]'$ where FE^G_t is the forecast error for the growth rate of government spending or some other measure of news about government spending. In the former specification, an innovation in G_t orthogonal to $\Delta G^F_{t|t-1}$ is interpreted as an unanticipated shock. In the latter specification, an innovation in the forecast error or news about government spending is interpreted as an unanticipated shock.[23] The key advantage of this approach is that, with sufficiently long series, we can have a VAR of a manageable size and yet we can remove directly a predictable component from government spending innovations.

With these alternative approaches and specifications, unanticipated shocks to government spending of a given initial size will lead to differing government spending responses over time. To make IRFs comparable, we normalize the size of the unanticipated government spending shock so that the integral of a government spending response over 20 quarters is equal to one. Therefore the interpretation of the fiscal multipliers is similar to the second column in Table 1. Figure 7 shows the IRFs for different approaches and specifications and contrasts these results with the results for the baseline specification (1)–(5) that does not control for the predictable component in government spending innovations. Table 1 reports the maximum and average multipliers along with associated standard errors.

[21] We do consider a more restricted version of this approach shortly, in which we add a series on defense spending innovations available for our full sample directly to the VAR.

[22] Mertens and Ravn (2010) distinguish anticipated and unanticipated shocks in a VAR by using long-run restrictions combined with calibration. We do not use this strategy in part because with regime switches we cannot distinguish long-run responses in expansions and recessions.

[23] In principle, these two variants should be the same, but this will not be exactly so because of data revisions. That is, we have real-time predicted changes, real-time actual changes, and ex post actual changes. The difference between the last two changes will be allocated to one piece or the other depending on which variable is included in the regression.

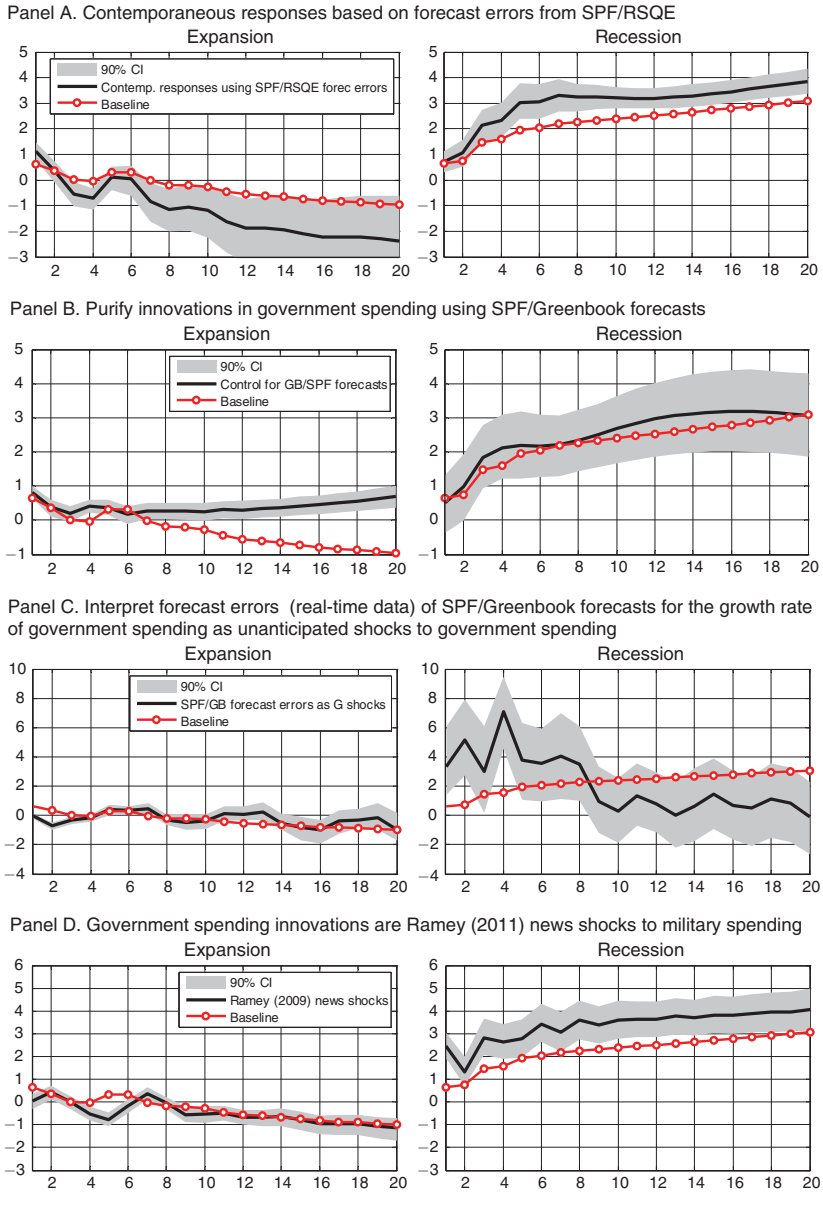

FIGURE 7. GOVERNMENT SPENDING MULTIPLIERS FOR PURIFIED UNANTICIPATED SHOCKS

Notes: The figure plots impulse response of output to an unanticipated government spending shock which is normalized to have the sum of government spending over 20 quarters equal to one. The lines with circles correspond to the responses in the baseline VAR specification. The shaded region is the 90 percent confidence interval.

Panel A (Figure 7) presents IRFs for the first approach. The results suggest that controlling for expectations increases the absolute magnitudes of the government spending multipliers, making them more positive in recessions and more negative in expansions. Panel B (Figure 7) shows results for the second approach with $\tilde{\mathbf{X}}_t = [\Delta G^F_{t|t-1} G_t T_t Y_t]'$ where $\Delta G^F_{t|t-1}$ is the spliced Greenbook/SPF forecast

series for the growth rate of government spending. In this specification, which is estimated on the 1966–2009 sample, the multiplier in the recession regime is a bit larger than in the baseline model while the multiplier in the expansion regime stays positive but small which contrasts with the baseline model where the multiplier turns negative at long horizons. By and large, these results suggest that the government spending multiplier in recessions increases and the multiplier in expansions stays close to zero when we purify government spending shocks of predictable movements.

Panel C (Figure 7) shows results for the second approach with $\hat{\mathbf{X}}_t = [FE_t^G \, G_t \, T_t \, Y_t]'$ where FE_t^G is the forecast error computed as the difference between spliced Greenbook/SPF forecast series and actual, first-release series of the government spending growth rate.[24] In this specification, an unanticipated shock to government spending in an expansion has an effect on output similar to the effect we find in the baseline model. In a recession, however, the multiplier may be larger than in the baseline model, especially at short horizons, but the standard errors for estimated output response are also rising which probably reflects the fact that forecast errors capture only a fraction of the variation in government spending.

Finally, we use spending news constructed in Ramey (2011) to control for the timing of fiscal shocks (Panel D, Figure 7). Specifically, we augment the baseline VAR with Ramey's spending news series, which is ordered first in this expanded VAR. The key advantage of using Ramey's series is that, in contrast to the forecast series, it covers the whole post-WWII sample (1949:I–2008:IV) and thus allows a longer estimation period and more precise estimates. One limitation of Ramey's news shocks is that they are based only on military spending. But changes in military spending do account for a large share of variation in total government spending, so they should still be informative. Also, these shocks are dominated by major historical events such as the Korean War which can make multiplier estimates sensitive to using alternative samples. Panel D shows that controlling for spending news does not materially affect output responses during expansions and raises responses in recessions, although increased standard errors call for cautious interpretation of these estimated impulse responses. We view these findings as corroborating our other evidence on the importance of constructing unanticipated fiscal shocks, which tend to have larger effects on output in recessions.

V. Concluding Remarks

Our findings suggest that all of the extensions we developed in this paper—controlling for expectations, allowing responses to vary in recession and expansion, and allowing for different multipliers for different components of government purchases—all have important effects on the resulting estimates. In particular, policies that increase government purchases have a much larger impact in recession than is implied by the standard linear model, even more so when one controls for expectations, which is clearly called for given the extent to which independent forecasts help predict VAR policy "shocks." Given the historical experience of the US economy,

[24] An advantage of using real-time data to compute forecast errors is that it makes forecasts and actual series refer to the same concept of government spending.

our preferred estimates of the government spending multiplier are between 0 and 0.5 in expansions, and between 1 and 1.5 in recessions.

While we have extended the SVAR approach, our analysis still shares some of the limitations of the previous literature. We have allowed for different economic environments, but there may be still other important differences among historical episodes that we lump together, for example recessions, such as the recent one, associated with financial market disruptions and very low nominal government interest rates, and other recessions induced by monetary contractions (such as the one in the early 1980s). Our predictions are also tied to historical experience concerning the persistence of policy shocks, and therefore may not apply to policies either less or more permanent. The effects of taxes, even if purged of expected changes, are still probably too simple as they fail to take account of the complex ways in which structural tax policy changes can influence the economy. And, finally, as we enter a period of unprecedented long-run budget stress, the US postwar experience, or even the experience of other countries that have dealt with more acute budget stress,[25] may not provide very accurate forecasts of future responses.

These limitations of our analysis should motivate future theoretical work to develop realistic DSGE models with potentially nonlinear features to understand more deeply the forces driving differences in the size of fiscal multipliers over the business cycle, the role of (un)anticipated shocks for fiscal multipliers in these environments, and implications of levels of government debt for the potency of discretionary fiscal policy to stabilize the economy.

Appendix: Estimation Procedure

The model is estimated using maximum likelihood methods. The log-likelihood for model (1)–(5) is given by:

$$\log L = const - \frac{1}{2}\sum_{t=1}^{T} \log|\Omega_t| - \frac{1}{2}\sum_{t=1}^{T} \mathbf{u}_t'\Omega_t^{-1}\mathbf{u}_t, \tag{A1}$$

where $\mathbf{u}_t = \mathbf{X}_t - (1 - F(z_{t-1}))\mathbf{\Pi}_E(L)\mathbf{X}_{t-1} - F(z_{t-1})\mathbf{\Pi}_R(L)\mathbf{X}_{t-1}$. Since the model is highly nonlinear and has many parameters $\Psi = \{\gamma, \Omega_R, \Omega_E, \mathbf{\Pi}_R(L), \mathbf{\Pi}_E(L)\}$, using standard optimization routines is problematic and, thus, we employ the following procedure.

Note that conditional on $\{\gamma, \Omega_R, \Omega_E\}$ the model is linear in lag polynomials $\{\mathbf{\Pi}_R(L), \mathbf{\Pi}_E(L)\}$. Thus, for a given guess of $\{\gamma, \Omega_R, \Omega_E\}$, we can estimate $\{\mathbf{\Pi}_R(L), \mathbf{\Pi}_E(L)\}$ with weighted least squares where weights are given by Ω_t^{-1} and estimates of $\{\mathbf{\Pi}_R(L), \mathbf{\Pi}_E(L)\}$ must minimize $\frac{1}{2}\sum_{t=1}^{T} \mathbf{u}_t'\Omega_t^{-1}\mathbf{u}_t$. Let

$$\mathbf{W}_t = \left[(1 - F(z_{t-1}))\mathbf{X}_{t-1} \quad F(z_{t-1})\mathbf{X}_{t-1} \quad \ldots \quad (1 - F(z_{t-1}))\mathbf{X}_{t-p} \quad F(z_{t-1})\mathbf{X}_{t-p}\right]$$

[25] See, for example, Perotti (1999) and Ardagna (2004).

be the extended vector of regressors and $\mathbf{\Pi} = [\mathbf{\Pi}_R \ \mathbf{\Pi}_E]$ so that $\mathbf{u}_t = \mathbf{X}_t - \mathbf{\Pi}\mathbf{W}_t'$ and the objective function is

$$\text{(A2)} \qquad \frac{1}{2}\sum_{t=1}^{T}(\mathbf{X}_t - \mathbf{\Pi}\mathbf{W}_t')'\mathbf{\Omega}_t^{-1}(\mathbf{X}_t - \mathbf{\Pi}\mathbf{W}_t').$$

Note that we can rewrite (A2) as

$$\begin{aligned}\frac{1}{2}\sum_{t=1}^{T}(\mathbf{X}_t - \mathbf{\Pi}\mathbf{W}_t')'\mathbf{\Omega}_t^{-1}(\mathbf{X}_t - \mathbf{\Pi}\mathbf{W}_t') \\ = trace\left[\frac{1}{2}\sum_{t=1}^{T}(\mathbf{X}_t - \mathbf{\Pi}\mathbf{W}_t')'\mathbf{\Omega}_t^{-1}(\mathbf{X}_t - \mathbf{\Pi}\mathbf{W}_t')\right] \\ = \frac{1}{2}\sum_{t=1}^{T} trace\left[(\mathbf{X}_t - \mathbf{\Pi}\mathbf{W}_t')'(\mathbf{X}_t - \mathbf{\Pi}\mathbf{W}_t')\mathbf{\Omega}_t^{-1}\right].\end{aligned}$$

The first order condition with respect to Π is $\sum_{t=1}^{T}(\mathbf{W}_t'\mathbf{X}_t\mathbf{\Omega}_t^{-1} - \mathbf{W}_t'\mathbf{W}_t\mathbf{\Pi}'\mathbf{\Omega}_t^{-1}) = 0$. Now using the *vec* operator, we get

$$\begin{aligned}vec\left(\sum_{t=1}^{T}\mathbf{W}_t'\mathbf{X}_t\mathbf{\Omega}_t^{-1}\right) = vec\left[\sum_{t=1}^{T}\mathbf{W}_t'\mathbf{W}_t\mathbf{\Pi}'\mathbf{\Omega}_t^{-1}\right] = \sum_{t=1}^{T} vec\left[\mathbf{W}_t'\mathbf{W}_t\mathbf{\Pi}'\mathbf{\Omega}_t^{-1}\right] \\ = \sum_{t=1}^{T}\left[vec\,\mathbf{\Pi}'\right]\left[\mathbf{\Omega}_t^{-1}\otimes\mathbf{W}_t'\mathbf{W}_t\right] = vec\mathbf{\Pi}'\sum_{t=1}^{T}\left[\mathbf{\Omega}_t^{-1}\otimes\mathbf{W}_t'\mathbf{W}_t\right],\end{aligned}$$

which gives

$$\text{(A3)} \qquad vec\mathbf{\Pi}' = \left(\sum_{t=1}^{T}\left[\mathbf{\Omega}_t^{-1}\otimes\mathbf{W}_t'\mathbf{W}_t\right]\right)^{-1} vec\left(\sum_{t=1}^{T}\mathbf{W}_t'\mathbf{X}_t\mathbf{\Omega}_t^{-1}\right).$$

The procedure iterates on $\{\gamma, \mathbf{\Omega}_R, \mathbf{\Omega}_E\}$ (which yields $\mathbf{\Pi}$ and the likelihood) until an optimum is reached. Note that with a homoscedastic error term (i.e., $\mathbf{\Omega}_t = const$), we recover standard VAR estimates.

Since the model is highly nonlinear in parameters, it is possible to have several local optima and one must try different starting values for $\{\gamma, \mathbf{\Omega}_R, \mathbf{\Omega}_E\}$. To ensure that $\mathbf{\Omega}_R$ and $\mathbf{\Omega}_E$ are positive definite, we use $\mathbf{\Psi} = \{\gamma, chol(\mathbf{\Omega}_R), chol(\mathbf{\Omega}_E), \mathbf{\Pi}_R(L), \mathbf{\Pi}_E(L)\}$, where *chol* is the operator for Cholesky decomposition. Furthermore, given the nonlinearity of the problem, it may be difficult to construct confidence intervals for parameter estimates as well as impulse responses. To address these issues, we use a Markov Chain Monte Carlo (MCMC) method developed in Chernozhukov and Hong (2003; henceforth CH). This method delivers not only a global optimum but also distributions of parameter estimates.

We employ the Hastings-Metropolis algorithm to implement CH's estimation method. Specifically our procedure to construct chains of length N can be summarized as follows:

Step 1: Draw $\boldsymbol{\Theta}^{(n)}$, a candidate vector of parameter values for the chain's $n+1$ state, as $\boldsymbol{\Theta}^{(n)} = \boldsymbol{\Psi}^{(n)} + \psi^{(n)}$ where $\boldsymbol{\Psi}^{(n)}$ is the current n state of the vector of parameter values in the chain, $\psi^{(n)}$ is a vector of i.i.d. shocks taken from $N(\mathbf{0}, \boldsymbol{\Omega}_{\Psi})$, and $\boldsymbol{\Omega}_{\Psi}$ is a diagonal matrix.

Step 2: Take the $n+1$ state of the chain as

$$\boldsymbol{\Psi}^{(n+1)} = \begin{cases} \boldsymbol{\Theta}^{(n)} \text{ with probability } \min\{1, \exp[\log L(\boldsymbol{\Theta}^{(n)}) - \log L(\boldsymbol{\Psi}^{(n)})]\} \\ \boldsymbol{\Psi}^{(n)} \text{ otherwise} \end{cases},$$

where $L(\boldsymbol{\Psi}^{(n)})$ is the value of the objective function at the current state of the chain and $L(\boldsymbol{\Theta}^{(n)})$is the value of the objective function using the candidate vector of parameter values.

The starting value $\boldsymbol{\Psi}^{(0)}$ is computed as follows. We approximate the model in (1)–(5) so that the model can be written as regressing $\mathbf{X}_t$ on lags of $\mathbf{X}_t, \mathbf{X}_t z_t, \mathbf{X}_t z_t^2$. We take the residual from this regression and fit equation (3) using MLE to estimate $\boldsymbol{\Omega}_R$ and $\boldsymbol{\Omega}_E$. These estimates are used as starting values. Given $\boldsymbol{\Omega}_R$ and $\boldsymbol{\Omega}_E$ and the fact that the model is linear conditional on $\boldsymbol{\Omega}_R$ and $\boldsymbol{\Omega}_E$, we construct starting values for lag polynomials $\{\boldsymbol{\Pi}_R(L), \boldsymbol{\Pi}_E(L)\}$ using equation (A3).

The initial Ω_{ψ} is calibrated to about one percent of the parameter value and then adjusted on the fly for the first 20,000 draws to generate 0.3 acceptance rates of candidate draws, as proposed in Gelman et al. (2004). We use 100,000 draws for our baseline and robustness estimates, and drop the first 20,000 draws ("burn-in" period). We run a series of diagnostics to check the properties of the resulting distributions from the generated chains. We find that the simulated chains converge to stationary distributions and that simulated parameter values are consistent with good identification of parameters.

CH show that $\overline{\boldsymbol{\Psi}} = (1/N)\sum_{n=1}^{N} \boldsymbol{\Psi}^{(n)}$ is a consistent estimate of Ψ under standard regularity assumptions of maximum likelihood estimators. CH also prove that the covariance matrix of the estimate of $\boldsymbol{\Psi}$ is given by $\mathbf{V} = (1/N)\sum_{n=1}^{N} (\boldsymbol{\Psi}^{(n)} - \overline{\boldsymbol{\Psi}})^2$ $= \text{var}(\boldsymbol{\Psi}^{(n)})$, that is the variance of the estimates in the generated chain.

Furthermore, we can use the generated chain of parameter values $\{\boldsymbol{\Psi}^{(n)}\}_{n=1}^{N}$ to construct confidence intervals for the impulse responses. Specifically, we make 1,000 draws (with replacement) from $\{\boldsymbol{\Psi}^{(n)}\}_{n=1}^{N}$ and for each draw we calculate an impulse response. Since columns of $chol(\boldsymbol{\Omega}_R)$ and $chol(\boldsymbol{\Omega}_E)$ in $\{\boldsymbol{\Psi}^{(n)}\}_{n=1}^{N}$ are identified up to sign, the generated chains for $chol(\boldsymbol{\Omega}_R)$ and $chol(\boldsymbol{\Omega}_E)$ can change signs. Although this change of signs is not a problem for estimation, it can sometimes pose a problem for the analysis of impulse responses. In particular, when there is a change of signs for the entries of $chol(\boldsymbol{\Omega}_R)$ and $chol(\boldsymbol{\Omega}_E)$ that correspond to the variance of government spending shocks, these entries can be very close to zero.

Given that we compute responses to a unit shock in government spending and thus have to divide entries of $chol(\Omega_R)$ and $chol(\Omega_E)$ that correspond to the government spending shock by the standard deviation of the government spending shock, confidence bands may be too wide. To address this numerical issue, when constructing impulse responses, we draw $\{\Pi_R(L), \Pi_E(L)\}$ directly from $\{\Psi^{(n)}\}_{n=1}^{N}$ while the covariance matrix of residuals in regime s is drawn from $N(vec(\Omega_s), \Sigma_s)$ where

$$\Sigma_s = 2[(\mathbf{D}_n'\mathbf{D}_n)^{-1}\mathbf{D}_n]\{\text{var}(vec(\Omega_s)) \otimes \text{var}(vec(\Omega_s))\}[(\mathbf{D}_n'\mathbf{D}_n)^{-1}\mathbf{D}_n]',$$

$\mathbf{D}_n$ is the duplication matrix, and $\text{var}(vec(\Omega_s))$ is computed from $\{\Psi^{(n)}\}_{n=1}^{N}$ (see Hamilton 1994 for more details). The 90 percent confidence bands are computed as the fifth and 95th percentiles of the generated impulse responses.

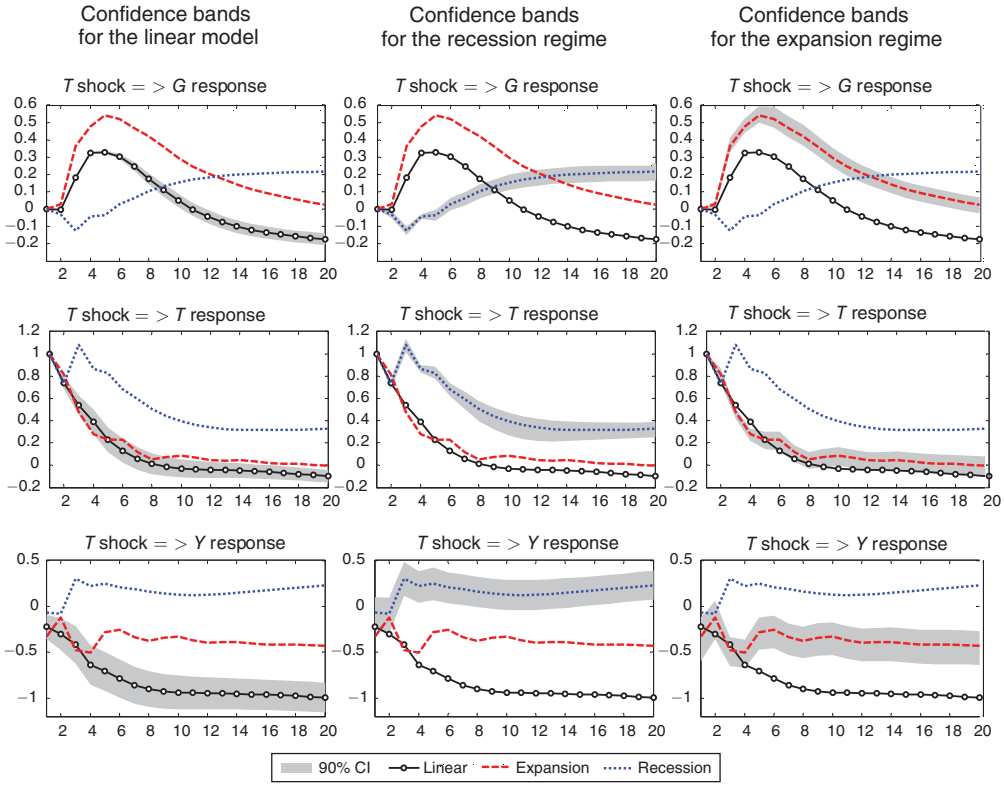

FIGURE A1. IMPULSE RESPONSES TO TAX SHOCKS

Notes: The figures show impulse responses to a $1 increase in taxes. To control for the automatic tax response to contemporaneous output shocks, we follow Blanchard and Perotti (2002) and use their estimate of 2.08 for the elasticity of tax revenues with respect output. The shaded region is the 90 percent confidence interval. Dashed lines show the responses in expansionary (long dash) and recessionary (short dash) regimes. The solid line with circles shows the response in the linear model.

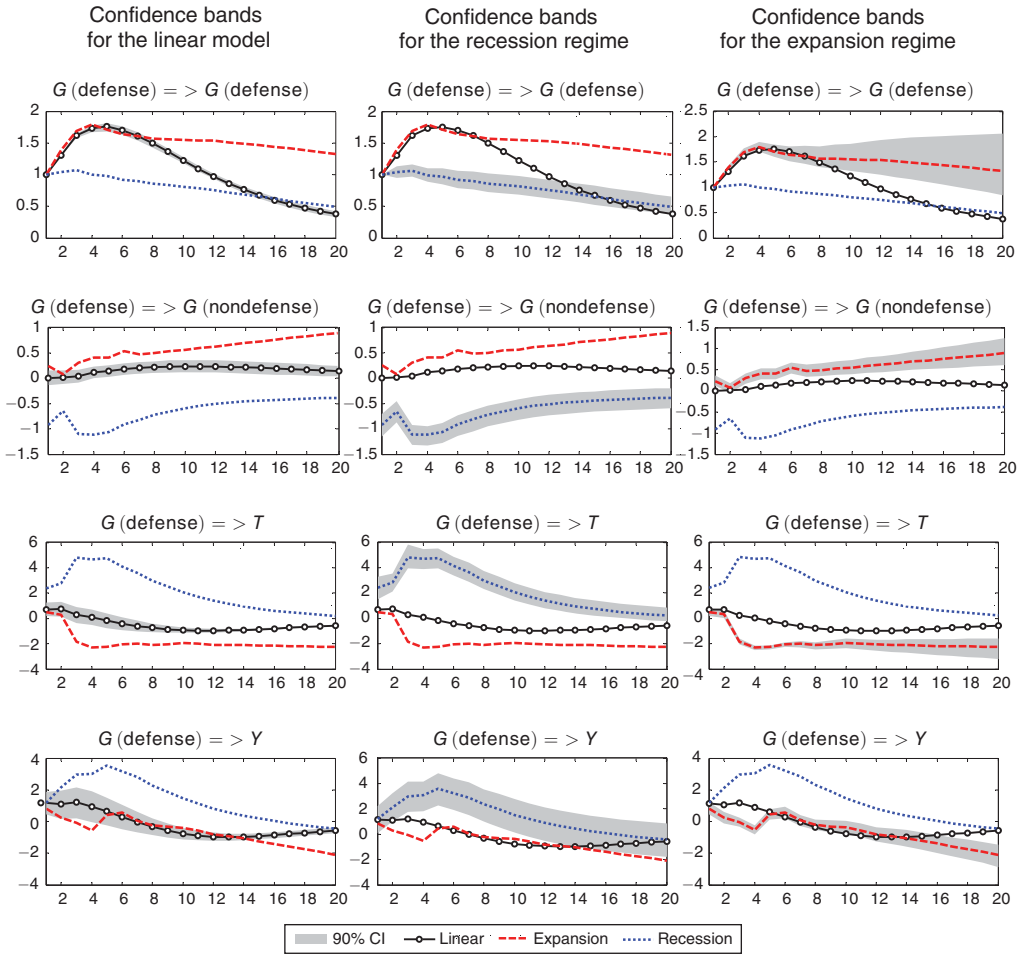

FIGURE A2. DEFENSE SPENDING

Notes: The figures show impulse responses to a $1 increase in government defense spending. Shaded region is the 90 percent confidence interval. Dashed lines show the responses in expansionary (long dash) and recessionary (short dash) regimes. The solid line with circles shows the response in the linear model.

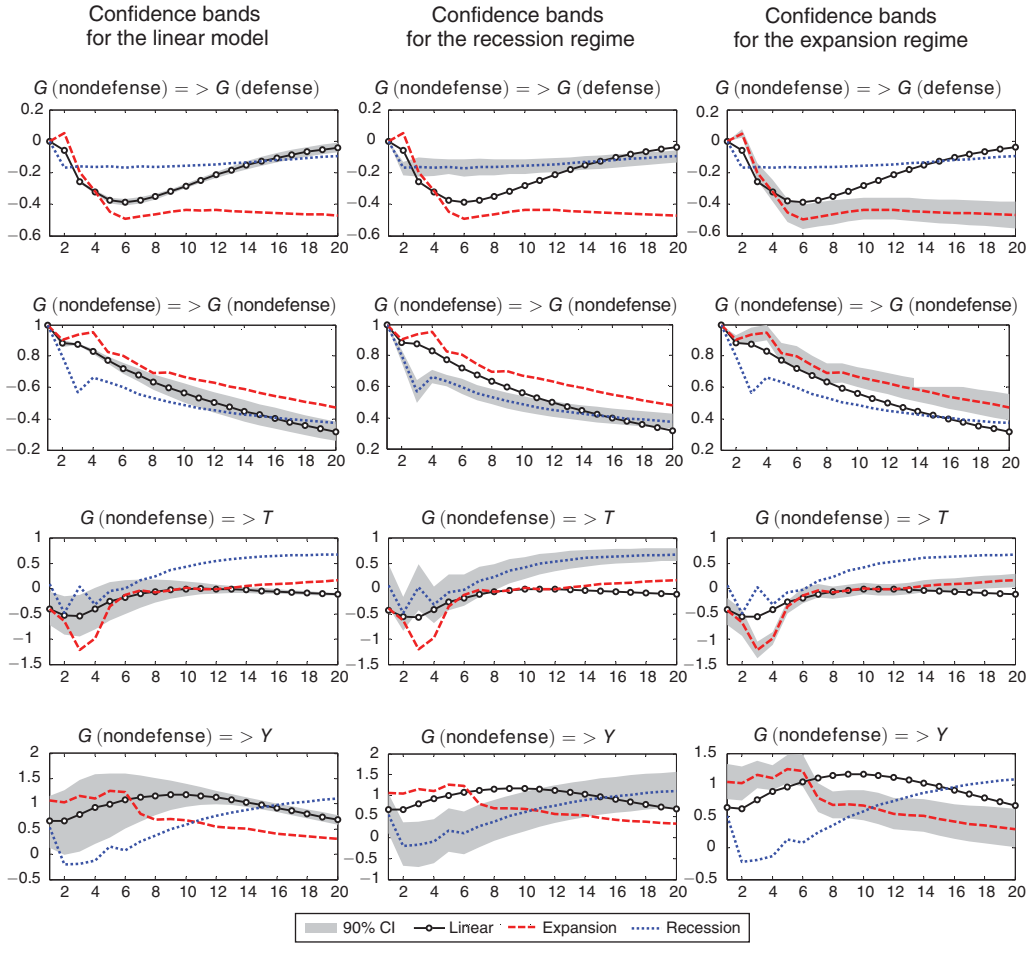

FIGURE A3. NONDEFENSE SPENDING

Notes: The figures show impulse responses to a $1 increase in government nondefense spending. Shaded region is the 90 percent confidence interval. Dashed lines show the responses in expansionary (long dash) and recessionary (short dash) regimes. The solid line with circles shows the response in the linear model.

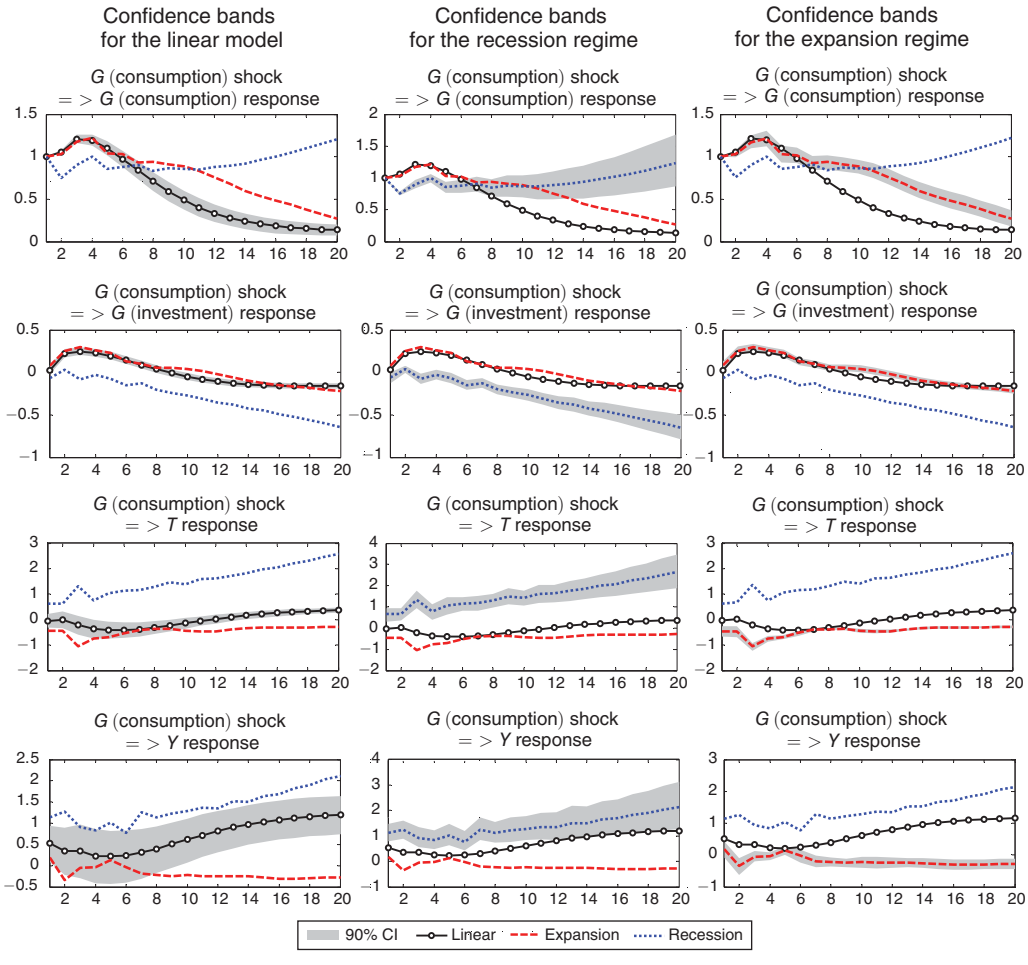

FIGURE A4. CONSUMPTION SPENDING

Notes: The figures show impulse responses to a $1 increase in government consumption spending. Shaded region is the 90 percent confidence interval. Dashed lines show the responses in expansionary (long dash) and recessionary (short dash) regimes. The solid line with circles shows the response in the linear model.

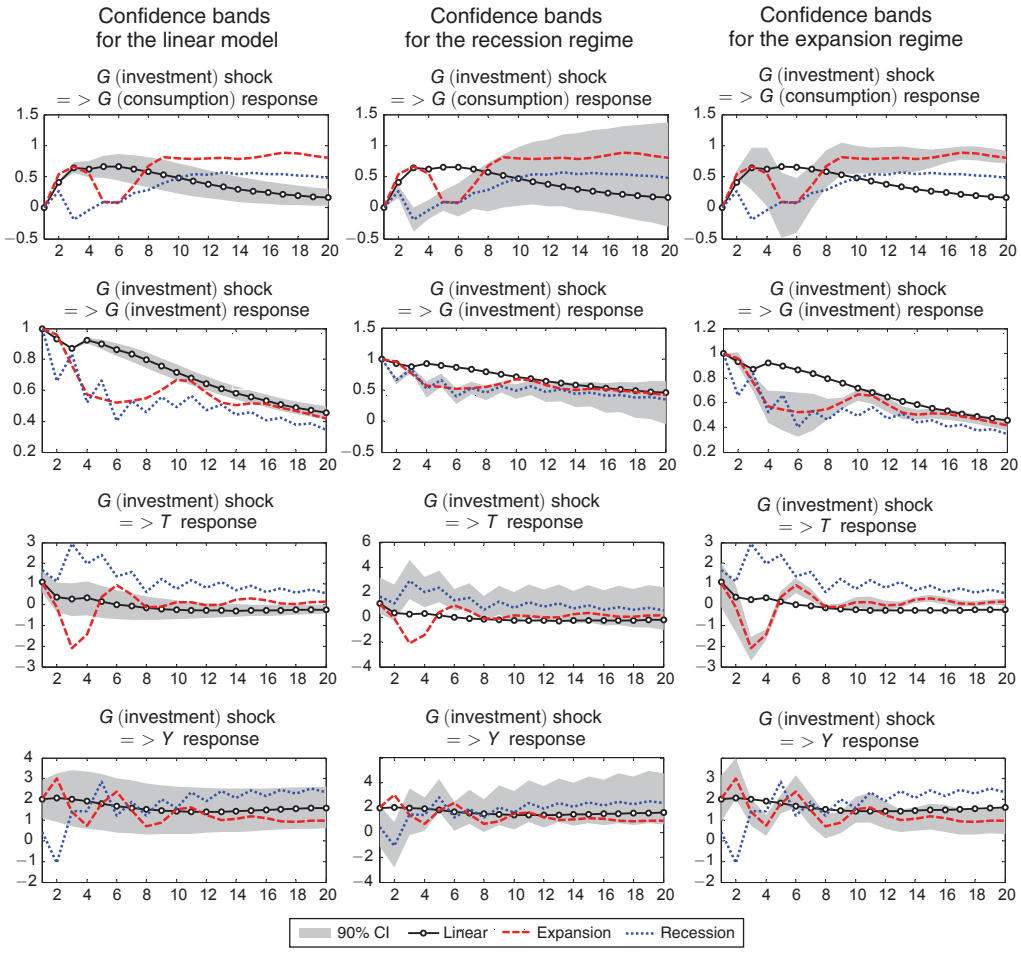

FIGURE A5. INVESTMENT SPENDING

Notes: The figures show impulse responses to a $1 increase in government investment spending. Shaded region is the 90 percent confidence interval. Dashed lines show the responses in expansionary (long dash) and recessionary (short dash) regimes. The solid line with circles shows the response in the linear model.

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