

# Taxes and the Labor Market<sup>1</sup>

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## Abstract

We estimate the effect of exogenous changes in taxes on the US unemployment rate and on several other labor market variables. Our estimates are based on a revised version of the Romer and Romer (2010) narrative record of exogenous tax innovations, with the additional benefit of distinguishing between capital income and labor income taxes. We first show that accounting for the difference between automatic and discretionary tax changes in the revised specification is crucial in order to obtain an unbiased measure of the tax multipliers. We then obtain the following main results. An increase in tax receipts of one percent of GDP has a sizeable positive impact on the unemployment rate, and a negative impact on hours worked, labor market tightness and job finding probability. The effect on GDP is also sizeable, but somewhat in the mid range of other values found in the literature, due to the fact that we account for the difference between discretionary and automatic changes in tax revenues. The effect on the unemployment rate of variations in business taxes is larger than that of personal income taxes. We suggest that the latter result poses interesting challenges for future research.

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## 1 Introduction

One of the defining features of the aftermath of the financial crisis of 2008-09 has been its persistent impact on the US labor market, with the unemployment rate roughly doubling from early 2008 through mid 2010 (see Figure 1). This has ignited an intense debate on the appropriate stimulus response of fiscal policy. This debate has revolved around two main issues: (i) the relative merits of higher government spending vs. tax cuts; (ii) the suitability of labor income vs. capital income tax cuts. In Monacelli, Perotti and Trigari (2010) we address part of the debate related to point (i). In that paper, however, we are mostly concerned with estimating the size of the unemployment multiplier of government spending. In this paper, we focus on the effects on the labor market of variations in taxes.

The idea that tax cuts are likely to be a more effective stimulus device than higher government spending is widespread in both the business and the academic community. This idea, however, often remains vague, for it typically does not distinguish between expansionary effects of tax cuts on GDP and its alleged, more specific, implications for the unemployment rate and the labor market as a whole. For instance, in a Wall Street Journal editorial on 29 January, 2009, Alberto Alesina and Luigi Zingales argue that "tax cuts have a much better effect on job-creation than highway rehabilitation", but propositions of this sort remain so far virtually untested in the literature.

Advocates of measures geared towards a cut in capital income taxes have mainly proposed two types of interventions. First, a reduction in capital gains taxes. The idea underlying this proposal is that this recession is unique because it originates from credit markets, where investors are still reluctant to lend to risky firms. Hence a reduction in capital gains taxes would boost the willingness of investors to take risks<sup>1</sup>. Skeptics of this proposal, however, mostly doubt the effectiveness of variations in capital gains taxes specifically on job creation. A second type of intervention that has been advocated is a reduction in depreciation allowances: firms that purchase new machines and other capital goods would be able to write them off immediately, instead of over many years<sup>2</sup>.

Some argue, however, that in a period of exceptionally low interest rates the latter measure is likely to have a limited impact, and insist on options mostly geared towards cuts in payroll taxes<sup>3</sup>. The argument is that a cut in payroll taxes would boost output and employment both by increasing demand for goods and services and by providing incentives for additional hiring; also, others have

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<sup>1</sup> This argument has been made, for instance, by Alesina and Zingales in the same WSJ editorial cited above.

<sup>2</sup> See for instance the Wall Street Journal editorial by Glenn Hubbard, September 10, 2010.

<sup>3</sup> Congressional Budget Office (2010).

noted that firms are hoarding a large share of profits but still perceive the cost of labor to be too high.<sup>4</sup>

Most of the recent debate on the alleged merits of tax cuts has revolved around whether or not extending the tax cuts enacted under President George W. Bush. These tax cuts refer to two laws passed in 2001 and 2003 under the Bush administration that reduced tax rates across the board on income, dividends and capital gains, as well as on other specific categories. The Obama administration has recently passed a temporary two-year extension of most of the Bush cuts as a part of a larger economic plan. Supporters of this measure have argued that a failure to extend the cuts would have implied an actual increase in taxes for the whole population by the end of 2010<sup>5</sup>.

According to the Congressional Budget Office, however, extending all of the Bush tax cuts may have a small "bang for the buck", the equivalent of a 10- to 40-cent increase in GDP for every tax dollar foregone. The argument (a classic one) goes that the Bush tax cuts mostly go to higher-income households, who have a relatively low marginal propensity to consume.<sup>6</sup>

Interestingly, of eleven potential stimulus policies the CBO recently examined, an extension of all of the Bush tax cuts seems to imply the lowest stimulus per tax dollar foregone.<sup>7</sup>

Therefore, some argue that the government could have more effectively stimulated the economy by letting the high-income tax cuts expire and use those savings for a combination of a job-creation tax credit and continued state fiscal assistance that would have allegedly generated "three times as much additional economic activity as using them to extend the high-income tax cuts" (Gale 2010, Marr 2010). Taking the CBO estimates literally, each of these measures is "estimated" to have roughly about three times the impact on GDP as continuing the Bush tax cuts.<sup>8</sup>

Different views about the extension of the tax cuts also depend on the perceived tradeoff between stimulus today and sustainability tomorrow. As reported by Gale and Harris (2010), former Obama administration budget director Peter Orszag has endorsed extending the Bush tax cuts for both middle-income taxpayers and the wealthy, but only for two years: temporary extension of the tax cuts "would keep the economy humming during the recovery", but a more permanent extension of

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<sup>4</sup> See for instance Roubini (2010).

<sup>5</sup> For instance, Rep. McConnell has reportedly said that "only in Washington could someone propose a tax hike as an antidote to a recession". Some Senate Democrats such as Kent Conrad of North Dakota, Evan Bayh of Indiana and Ben Nelson of Nebraska have also argued "against raising taxes on anyone during a fragile economic recovery" (Gale and Harris (2010)). As another example, Bill Rys, tax counsel for the National Federation of Independent Business, a small-business group, has argued that "[t]he best thing to do is to get rid of uncertainty, and that includes the cliff we're falling off with all these [tax] provisions that are expiring," (Weisman and McKinnon 2010).

<sup>6</sup> In work in progress, Monacelli and Perotti (2011) explore (both empirically and theoretically) precisely the issue of whether "pro-poor" tax cuts (i.e., tax cuts favoring households in the lower brackets of the income distribution) are more expansionary than tax cuts that redistribute in favor of the "rich".

<sup>7</sup> See CBO (2010), Table 1.

<sup>8</sup> See CBO (2010), Table 1.

the tax cuts---even if limited to middle-income households---"is simply unaffordable because of the impact on the deficit". Alan Greenspan, former chairman of the Federal Reserve, called an extension of the Bush tax cuts without corresponding spending reductions "disastrous".<sup>9</sup>

These quotations do only partial justice to the complex ramifications of the current debate on the appropriate size and composition of the response of fiscal policy to the Great Recession. That debate, however, almost invariably relies on rather unstructured empirical evidence on the effects of tax changes on the macroeconomy, let alone on the labor market. As an illustration, CBO (2010) reports that "low and high estimates of multipliers for a given policy were chosen, on a judgmental basis, to encompass most economists' views about the effects of that type of policy".

As exemplified by the above discussion, tax changes can occur for a variety of reasons, including (as it is mostly the case in the current recession) as endogenous reaction to the state of the economy. But in order to gauge the economic and quantitative significance of any tax measure, one needs to identify those changes that happen for reasons unrelated to current (and/or anticipated) developments in the economy.

In this paper we study the effect of *exogenous* variations in taxes on the US unemployment rate and on several other labor market variables. Our estimates are based on a revised version of the Romer and Romer (2010) narrative record of exogenous tax innovations.<sup>10</sup> There are two main differences in our data set relative to that of Romer and Romer: first, while they use data on tax liabilities, we track the quarterly exogenous changes in receipts generated by each tax bill; second, we distinguish between different types of taxes: personal, corporate, indirect, social security, and several subcomponents of each of these.<sup>11</sup> Using this disaggregation, in this paper we begin to address some of the policy issues quoted above, although not yet at the level of detail that one might like: for instance, there is not enough variation in the post-war time series to address issues like the relative merits of capital gains taxation vs. employment tax credits.

Our results are based also on a different empirical methodology from that used by Romer and Romer: following Perotti (2010), we show that accounting for the difference between automatic and discretionary tax changes is crucial to obtain an unbiased measure of the effects of tax changes. By doing so, we find estimates of the effects of tax shocks that are typically in between the extremely large effects estimated by Romer and Romer, and the much smaller (and often statistically insignificant) effects estimated by Favero and Giavazzi (2010).

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<sup>9</sup> See Gale and Harris (2010).

<sup>10</sup> We do not address here the distinction between anticipated and unanticipated tax innovations, as done, for instance, in Mertens and Ravn (2009).

<sup>11</sup> See Perotti (2010) for more details.

We obtain the following main results. First, an increase in tax liabilities of one percent of GDP has a sizeable positive impact on the unemployment rate and a sizeable negative impact on GDP, hours worked, employment, labor market tightness and the job finding probability. For instance, under our preferred empirical specification, the unemployment rate increases -after six quarters- by .50 percentage points and GDP falls by 1.2 percent. Second, we find that the data set matters. When we employ exactly the original Romer and Romer (2010) specification but with our data set, the size of virtually all estimated multipliers decline substantially in absolute value. Third, we find that the multiplier on private investment is particularly large and persistent, with investment contracting by about 5 percent after 6 and 12 quarters. Fourth, the effect on GDP and on labor market variables of shocks to taxes on business is typically larger than the effect of shocks to labor income taxes. In the conclusions we discuss some of the possible theoretical implications of this result.

The outline of the paper is as follows. In the next section we present our estimation methodology. Section 3 briefly discusses the data. Section 4 presents the main results. In section 5, we show the effects of the main types of taxes. Section 6 concludes.

## 2 Estimates of discretionary taxation

In this section we introduce our methodology to estimate the effects of discretionary taxation<sup>12</sup>.

### 2.1 Romer and Romer (2010) and Favero and Giavazzi (2010)

Romer and Romer (2010) (R-R henceforth), estimate an equation of the type:

$$(1)$$

where  $y_t$  is the variable of interest,  $\tau_t$  is a measure of tax shocks constructed by R-R based on the original documentation accompanying tax bills, and  $L$  is a lag polynomial of order  $n$  (in R-R,  $n=12$ , i.e.,  $L^n$  includes powers 0 to 12 of the lag operator  $L$ ). For future reference, we call this the "R-R one equation specification". R-R typically find that, in response to a tax shock of 1 percentage point of GDP, output declines by up to three percent within three years. These effects have appeared to many as implausibly large.

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<sup>12</sup> See again Perotti (2010) for more details on the methodology. Chahrour, Schmitt-Grohe and Uribe (2010) use a DGSE model to compare a SVAR-based identification strategy of tax shocks to one based on narrative records. They conclude that the different tax multipliers obtained from the SVAR and narrative approaches do not depend on differences in the transmission mechanism, but rather on either a failure to identify the same tax shock or to small sample uncertainty.

In fact, Favero and Giavazzi (2010) (F-G henceforth) argue that these results are due to an erroneous specification of the regression to be estimated. They argue that equation (1) cannot be derived from the correct truncated MA representation of any underlying VAR. Let the vector include  $n$  endogenous variables of interest, say output  $y_t$ , government spending  $g_t$ , the interest rate  $r_t$ , government revenues  $r_g$ , and a labor market variable such as the unemployment rate. One should then treat the R-R tax shocks as exogenous variables in a reduced form VAR in  $\mathbb{R}^n$ . Formally this corresponds to the following model:

$$(2)$$

where  $\Phi(L)$  is a lag polynomial of order 4,  $\alpha$  is a vector and  $\epsilon_t$  is a vector of reduced form residuals. F-G estimate (2) by OLS, and argue that the correct impulse responses are obtained by simply tracing the dynamic effects of a shock to  $\epsilon_t$  of one percentage point of GDP. For future reference, we call the one in equation (2) the "OLS F-G specification".

Notice that if one is interested only in the effects of the R-R tax shocks, there is no need to go beyond this reduced form specification, provided the two identifying assumptions of R-R are satisfied: (i)  $\epsilon_t$  is orthogonal to  $\mathbb{R}^n$ , and (ii)  $\epsilon_t$  is unpredictable using lagged variables in the information set of the econometrician. F-G find that a one percentage point of GDP realization of  $\epsilon_t$  causes a decline in output by less than one percent, and often insignificant.

The correct truncated MA representation of (2) is:

$$(3)$$

where  $\Phi(L)$  is a lag polynomial of order  $k$ ,  $\alpha$  is of the same order as  $\Phi(L)$ , and  $\epsilon_t$  is a moving average of  $\epsilon_t$ . As Favero and Giavazzi (2010) argue, a comparison of (1) with the first row of (3) shows that R-R's equation (1) does not correspond to the first equation of the truncated MA representation of the original VAR, because R-R omit the lagged values of the endogenous variables<sup>13</sup>.

## 2.2 Discretionary and automatic tax changes

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<sup>13</sup> R-R also estimate a version of (1) that includes lags 1 to 4 of  $y_t$ , but this does not address the criticism raised by F-G.

Perotti (2010) argues that the specification adopted by F-G is also incorrect if one wants to capture the dynamic effects of the R-R tax shocks. The reason is that changes in tax revenues are the combination of discretionary changes to taxation, which reflect intentional actions of the policymakers like changes in tax rates, depreciation allowances, deductions, etc., and automatic changes to revenues, which reflect the effects of output, inflation etc. on tax revenues, for given tax rates.

Let therefore tax revenues be given by the following expression:

(4)

where  $\Delta \tau$  (the R-R tax shocks) captures the changes in discretionary taxation,  $\Delta \tau$  is a vector of endogenous variables that includes the same variables as  $\Delta \tau$ , except  $\Delta \tau$ , and  $\Delta \tau$  is a vector of coefficients. For simplicity, we will refer to the term  $\Delta \tau$  as the "automatic" component of tax changes.

Perotti (2010) argues that the discretionary and the automatic components of changes in tax revenues are likely to have different effects on output. One can think of at least two reasons for this. First, discretionary changes are more distortionary, because they consist of changes in both tax rates and tax rules. Second, discretionary tax changes are likely to be more persistent. In order to see this, suppose taxation is defined with reference to trend or potential output, so that deviations of output from the reference level sum to zero over the cycle. In this case, if agents are not liquidity constrained, the automatic component of taxation should have no effect on the agents' behavior, because neither tax rates nor the present value of tax payments change<sup>14</sup>.

In light of this distinction, the correct specification of the model is not (2), but (4) combined with the VAR:

(5)

where  $\Delta \tau$  is a lag polynomial of order 5. Combining (4) and (5) one obtains:

(6)

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<sup>14</sup> One could argue that a purely cyclical source of changes in revenues could matter if individuals are moved into different tax brackets, so that the average marginal income tax rate changes. This effect is however likely to be second order.

where  $D_0$  is the vector of coefficients of  $\Delta x_t$  when  $\Delta x_t$  and  $\Delta x_{t-1}$  is a lag polynomial of order 4 defined as

Rearranging, (6) yields:

$$(7)$$

where  $\Delta x_t = \Delta x_{t-1} + \Delta x_{t-2} + \Delta x_{t-3} + \Delta x_{t-4}$ , and  $\Delta x_{t-1} = \Delta x_{t-2} + \Delta x_{t-3} + \Delta x_{t-4}$ .

Mertens and Ravn (2010) (M-R henceforth) perform an OLS regression of  $\Delta x_t$  on its lags and on  $\Delta x_{t-1}$  and its lags, therefore treating the term  $\Delta x_{t-1}$  in (7) as the error term. We will refer to the one in (7) as the ‘‘OLS M-R specification’’.

However, the OLS M-R approach gives biased estimates because  $\Delta x_{t-1}$  is likely to be correlated with  $\Delta x_t$ . The solution is to take  $\Delta x_t$  and its lags out of the error term and include them explicitly as regressors in (7). This can be done by an instrumental variable estimation of (4), which allows one to recover an estimate of  $\Delta x_t$ <sup>15</sup>. The natural instruments for the variables in  $\Delta x_t$  in (4) are lags of  $\Delta x_t$  and lags of  $\Delta x_{t-1}$ . We call this the ‘‘IV M-R specification’’.

As we will see, IV and OLS M-R estimates are similar, and both display much stronger effects on all endogenous variables than the OLS F-G specification. We now show that both these observations are relatively easy to explain in our context.

To see why the OLS F-G specification is likely to lead to attenuated estimates of the effects of a tax shock, use (7) to replace the vector  $\Delta x_t$  in (4). This gives:

$$(8)$$

Stacking (7) and (8), and collapsing the polynomials in  $\Delta x_t$  and the terms in  $\Delta x_{t-1}$  in the error terms of each equation of the resulting system, it is easy to see that one can ‘‘almost’’ reproduce the F-G reduced form specification (2), except that the lags of  $\Delta x_t$  in the latter are replaced in (8) by lags of  $\Delta x_{t-1}$ .

Consider therefore an OLS estimation of the F-G specification (2), when the true model is given by (7) and (8). There are two sources of bias in the OLS F-G approach. The first is the same as in the OLS M-R approach: the lags of  $\Delta x_t$  are likely to be correlated with the lags of  $\Delta x_{t-1}$ . The second

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<sup>15</sup> To do so, one needs a third identifying assumption, in addition to the RR assumptions:  $\Delta x_t$  should be uncorrelated with current and past values of  $\Delta x_{t-1}$ .



source of bias stems from the inclusion of lags of  $\Delta \tau_t$  instead of lags of  $\tau_t$ . The difference between  $\Delta \tau_t$  and  $\tau_t$  has two components. The first is  $\tau_{t-1}$ , which gets incorporated in the polynomial on the right hand side of (8) and does not cause any harm; the second component,  $\epsilon_t$ , introduces a classic error in variable problem. As it is well known, error in variables typically biases estimated coefficients towards zero. The solution to both problems consists once again in taking  $\Delta \tau_t$  and its lags out of the error term, generating the IV F-G estimates. In fact, it can be shown that, if one used exactly the same instruments to estimate (4), the IV F-G and IV M-R estimates are numerically identical.

To see why the OLS M-R and IV M-R estimates are very close to each other, note that when  $\tau_t = 0$  in (5), so that automatic tax changes have no effects, OLS M-R responses are consistent because lagged values of  $\Delta \tau_t$  do not appear in the error term. Thus, the fact that OLS M-R and IV M-R responses are close is an indication that the effects of automatic tax changes are negligible.

Note that OLS F-G responses continue to be inconsistent, because it remains true that this specification has lags of  $\Delta \tau_t$  instead of  $\tau_t$ . If instead  $\tau_t = 0$ , so that the two components of tax changes have the same effects, OLS F-G responses are consistent, because  $\tau_t$  is the right variable to have in the system. The intuition is clear: in this case, there is no need to decompose lags of  $\Delta \tau_t$  into the discretionary and the automatic components.

### 2.3 Back to Romer and Romer

We have seen that the original R-R approach, as exemplified by equation (1), has problems in small samples because it omits some terms of the truncated MA representation. F-G's version of the truncated MA representation, equation (3), includes these terms but has the problem that it does not allow for different effects of the discretionary and automatic components of tax changes. The correct truncated MA representation can be derived from (7) and takes the form:

$$(9)$$

where  $\Delta \tau_t$  is a lag polynomial of order  $p$ ,  $\tau_t$  is of the same order as  $\Delta \tau_t$ , and  $\tau_t$  is a moving average of  $\Delta \tau_t$  and  $\tau_t$ . Henceforth we call this the “OLS augmented R-R specification”. Note the difference with (3), which includes  $\Delta \tau_t$  among the endogenous variables, while (9) does not.

Once again, an OLS estimate of (9) generates biased impulse responses because of the correlation between lags of  $\Delta \tau_t$  in the error term and lags of  $\tau_t$ . The solution, as usual, is to take lags of  $\Delta \tau_t$  out of the error term; we denote the resulting specification the “IV augmented R-R specification”.

### **3 The data**

Perotti (2010) presents a new set of data that extends the R-R data in several dimensions. That paper provides full details on the construction of the data; here we summarize the main points. First, the aggregate tax shocks are divided into four main categories: (i) personal, (ii) corporate, (iii) social security, and (iv) indirect taxes, as well as several subcategories. We exploit this disaggregation in section 5.

Second, unlike R-R, who collect data on liabilities, Perotti (2010) collects data on both receipts and liabilities, whenever the distinction is made in the sources. In this paper, we use receipts, although the difference in effects between receipts and liabilities is small.

Third, R-R typically report the effect of a tax legislation as the first full year effect of liability changes after enactment, and attribute that number to the quarter of enactment. But there are cases where a tax legislation manifests its effects gradually over several quarters. For instance, accelerated depreciation typically causes a large change in the time profile of receipts, but a small change in their present discounted value: receipts decline initially but increase later. Using the first full-year effect would therefore provide a distorted picture of the effects of the tax measure. Whenever possible, Perotti (2010) follows the effects of tax legislation over time.

Fourth, while R-R attribute all the effects of retroactive changes to the first quarter of enactment, Perotti (2010) keeps track of the effects of retroactive measures over time. This can make a considerable difference, particularly in the case of corporate income taxation.

### **4 Estimates**

In this section we present the results of our empirical analysis, based on a battery of alternative specifications and decompositions of the data set.

#### **4.1 Specifications**

To summarize the discussion of the previous section, we estimate the following specifications:

##### **Romer-Romer (R-R) one equation specification**

(10)

where  $\Delta y_{it}$  is of order 13 and  $y_{it}$  is the variable of interest.

### **Augmented Romer-Romer (R-R) specification**

(11)

where  $\Delta y_{it}$  is of order 13 and  $\Delta x_{it}$  of order 4. The vector  $x_{it}$  includes the log change of real per capita output  $\Delta \ln y_{it}$ , the log change of real primary government spending per capita  $\Delta \ln g_{it}$ , the first difference of the interest rate  $\Delta r_{it}$ , and the first difference of a labor market variable, each considered in turn (see more below). As suggested above, this is a multidimensional extension of the original R-R one-equation regression, with the addition of lags 13 to 16 of the endogenous variables, as it should be if the MA representation is truncated correctly.

### **Favero-Giavazzi (F-G) specification**

(12)

with  $\Delta x_{it}$  of order 4.

### **Mertens-Ravn (M-R) specification**

(13)

where  $\Delta y_{it}$  and  $\Delta x_{it}$  are of order 5 and 4, respectively.

All specifications described above also include a constant. To maximize comparability with Romer and Romer (2010), in the baseline case we estimate all these specifications in first differences. All these specifications, except the R-R one equation specification, are estimated by both OLS and IV, as discussed above. In the latter case, the set of regressors includes also the moving average (lags 0 to 4) of the series  $\Delta y_{it}$  obtained by IV estimation of (4), using as instruments lags 1 to 4 of the variables included in the vector  $x_{it}$ , and lags 0 to 4 of  $\Delta y_{it}$ <sup>16</sup>.

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<sup>16</sup> In the case of the F-G specification, the set of instruments includes also lags 1 to 4 of  $\Delta y_{it}$  and only lag 0 of  $\Delta y_{it}$ .

In all cases the initial shock is a realization of the R-R tax shock of 1 percentage point of GDP. We report both 68 percent confidence bands, that have been used extensively in the recent empirical fiscal policy literature, and the more traditional 95 percent confidence bands<sup>17</sup>. Standard errors are obtained by bootstrapping with 1000 replications. We display both the point estimates of the impulse responses and the median response of the replications. In most cases, the two impulse responses are indistinguishable in the figures.

**Sample** The sample of Perotti (2010)'s data on is 1945:1 – 2008:2 (the sample of R-R data is 1947:1 - 2006:2). The other constraints on the sample are the series on the log change in GDP, government spending, and revenues per capita, that start in 1948:2<sup>18</sup>. With four lags of the endogenous variables as instruments, the estimated series starts in 1949:2; and since at least four lags of the endogenous variables appear in each specification, the earliest starting date of an IV estimate is 1950:2.

**Labor market variables** We consider the following labor market variables: the unemployment rate, the log of unemployment, and the log of the labor force (the latter two variables divided by population)<sup>19</sup>; the job finding probability (calculated using data on unemployment and short term unemployment as in Shimer, 2005), labor market tightness (the ratio of vacancies to unemployment), the log of vacancies (as a share of the population), and the separation rate (also calculated following Shimer, 2005); the log of employment and hours in the private sector and in manufacturing, all as shares of the population;<sup>20</sup> the log of the real product wage in manufacturing and in the business sector;<sup>21</sup> and the markup in manufacturing and in the non financial business sector.

## 4.2 Results

In Figures XX to XX we show the impulse responses to shocks to taxes for the alternative methodologies described above (for the R-R one equation specification, we only report the multipliers in Table 1 below).

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<sup>17</sup> In their original work, R-R mostly display 68 percent confidence bands.

<sup>18</sup> The NIPA data on the levels of these variables start in 1947:1, but in the FRED dataset the data on population starts in 1948:1. The interest rate is defined as the average cost servicing the debt, and it is constructed by Favero and Giavazzi (2010) by dividing net interest payments at time  $t$  by the federal government debt held by the public at time

<sup>19</sup> Here and in what follows, "population" stands for "population age 16 and above".

<sup>20</sup> Total nonfarm employment and civilian employment behave almost exactly like private employment, and the same for hours.

<sup>21</sup> These are obtained by dividing the nominal wages by the producer price index.

**Favero-Giavazzi OLS specification** Figure ?? displays responses from an OLS F-G specification. Private consumption and private investment all decline, but by much less than estimated by R-R; GDP even increases slightly, although with very large standard errors. All labor market variables also move very little, and never significantly at the 95 percent level of confidence. The unemployment rate increases by a mere .15 percentage points at the peak, and the response is entirely insignificant even at the 68 percent level. As we have already argued above, if indeed the discretionary and automatic components of fiscal policy have different effects, an attenuated response to a discretionary tax shock is what we should expect.

**Mertens-Ravn IV specification** Figure ?? displays responses from the IV M-R specification. The responses are now much stronger. GDP falls by 1.2 percent after 6 quarters, less than half the decline estimated by R-R, but still much more than the F-G estimate; private consumption falls by .7 percent, and private investment by about 5 percent, again in between the R-R and F-G estimates. The standard error bands are now much tighter; the GDP and private investment responses are significant at the 95 percent level, the consumption response only at the 68 percent level. Private investment also declines, but the response is significant only at the trough of 3 percent after 3 quarters.

Qualitatively, all labor market variables move in a direction which is economically meaningful.<sup>22</sup> In all cases (with the exception of the real wage and the markup) the responses are significant or nearly significant at the 95 percent level, usually after a few quarters. The unemployment rate increases gradually, reaching a peak of about .6 percentage points after 6 quarters, and then stabilizes at that level. The next two panels of the first row show that most of the action comes from the increase in unemployment, but there is also a decline of the labor force participation by about .2 percent, although significant only at the 68 percent level.

The job finding probability falls gradually, reaching a peak reduction of about three percentage points after 2 years. Similarly, labor market tightness falls gradually by almost 20 percent after 2 years. This decline is due in almost equal measure to a decrease in vacancies and to an increase in unemployment (see the second panel of the second row and the third panel of the third row). The separation rate increases by about .15 percentage point after one year. This implies that both the hiring and the separation margin contribute considerably to the decrease in employment.

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<sup>22</sup> We do not employ a formal theoretical model in this version of the paper, but these results are all qualitatively consistent with a benchmark RBC model with search and matching frictions in the labor market, like the one in Monacelli, Perotti and Trigari (2010), which is used to study the effects of government spending. See more below on this point.

The third row displays the responses of private and manufacturing employment and hours. Hours decline, by about 1 percent in both sectors; both are significant at the 95 percent level. Virtually all the response of hours is due to the extensive margin: employment tracks hours almost exactly. Finally, the real wage and the markup in manufacturing and in the business sector (last row) move little, and the standard errors tend to be large.

The OLS estimates of all these responses obtained under the Mertens and Ravn specification (not shown) are very similar to the IV estimates displayed here; as discussed above, this is consistent with the effect of the automatic component of tax changes, captured by  $\tau$ , being small. In contrast, the IV responses of the Favero-Giavazzi specification (also not shown)<sup>23</sup> are different from the corresponding OLS responses displayed in Figure ??: this is consistent with a large difference between the effects of the discretionary and of the automatic components of tax changes.

**Romer and Romer augmented MA specification** As a comparison, it is interesting to display the responses of the augmented OLS R-R MA specification (see Figure ??). As we have seen, this is a multidimensional extension of the original R-R one-equation regression. The responses are often slightly stronger than the IV M-R responses, and the standard errors bands tighter. In particular, unemployment increases more, and hours, employment and GDP decline more. There is also more evidence of an increase in the product wage, particularly in manufacturing, where it rises by 2 percent after 2 years, and significant at 95 percent level. These results are consistent with Perotti (2010), who shows that IV M-R responses of output are often in between the large responses estimated by R-R (though with a single equation approach rather than an augmented R-R specification as here) and the small responses estimated by F-G.

**Multipliers** Table 1 summarizes the main results in terms of "tax multipliers". It displays the (point estimates of the) impulse responses of the main variables of interest, respectively at 6 and 12 quarters, for the three alternative methodologies: OLS F-G, IV M-R, and OLS R-R augmented MA. In addition, in the first two rows we also display responses from the one equation R-R specification, estimated with the original R-R data and with our data. Recall that the underlying tax shock is normalized to 1 percent point of GDP.

Four observations stand out. First, the R-R one equation specification does deliver much stronger responses. In the first row, where we use the original R-R data on the tax shocks, the unemployment effect at 12 quarters is 1.10, the GDP effect -2.74 (as in Romer and Romer (2010)), and the

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<sup>23</sup> As discussed above, IV F-G responses are very similar to IV M-R responses, and numerically identical if the same instruments are used to estimate equation (4).

investment effect an impressive -9.69 percent. These numbers are about 2 to 3 times larger than the IV M-R effects.

Second, the tax data do make a difference: in the second row, where we use our own estimates of the tax shocks, the effects on virtually all variables decline in absolute value, although they usually remain larger than in the IV M-R specification. From now on, the results we report use our estimates of the tax shocks.

Third, the augmented R-R specification (the multivariate extension of the one equation R-R specification) still tends to deliver higher estimates of the unemployment and the GDP effects than the IV M-R specification. In contrast, and as we discussed, the F-G specification features much smaller and often insignificant multipliers. Under our preferred specification (IV M-R), the unemployment rate rises by .54 percentage points after 6 quarters, whereas GDP falls by .93 percent; the responses at 12 quarters are almost identical. Noticeably, both the unemployment and the GDP multipliers estimated under the IV M-R specification are a bit smaller than the corresponding multipliers of government spending that we estimated in Monacelli, Perotti and Trigari (2010).

Fourth, the investment multiplier is sizeable, both in the IV M-R and in the augmented R-R specifications (after 6 quarters, -3.88 percent and -2.93 percent respectively, although in the latter case it is estimated rather imprecisely). Once again, and at both horizons, the effect on investment under the F-G specification is smaller and not statistically significant.

**[Insert Table 1 here]**

## **5 Labor and corporate income taxes**

One benefit of the dataset we use is that it allows us to distinguish between different types of taxes. Table 2 lists the four main categories of taxes and their subcategories. The sum of all these items is the aggregate taxes that have been used so far.

**[Insert Table 2 here]**

We now re-group taxes into three main categories: (i) Labor income taxes; (ii) Business taxes I; (iii) Business taxes II. Labor income taxes include personal income taxes, except for items 4 and 5 (capital gains taxes and depreciation allowances), and social security taxes. Business taxes I include corporate income taxes and items 4 and 5 of personal income taxes; Business taxes II also includes indirect taxes. We summarize our categories in Table 3 below.

**[Insert Table 3 here]**

Figure 5 displays the results. We only display the responses of the main variables: for instance, we have seen that the impulse responses of tightness and of vacancies track the response of the job finding probability very closely, hence we only display the latter.

The effects of labor income taxes are virtually identical to those of all taxes combined. In contrast, the effects of the two types of business taxes are stronger, particularly under the second definition; the first definition tracks the second one closely in the first year, but then returns to the stochastic trend more quickly.

Under the second definition, a shock to business taxes raises the unemployment rate by twice as much as a shock to labor income taxes of the same size; similarly, it causes a decline in the job finding probability, employment in the private sector, GDP and private investment by twice as much or more. It also causes a 3 percent decline in the business sector wage, which instead does not move in response to a shock to labor taxes or total taxes.

Figures 6 and 7 display the responses to shocks to labor income taxes and to the second definition of business taxes, respectively, now including their 68 and 95 percent standard error bands. The figures display also the responses to shocks to total taxes (the dashed line). As we have seen, the responses to labor income taxes differ minimally from the responses to total taxes, and the standard errors are only slightly larger. With corporate income taxes, the responses are always significant at the 95 percent level; they are also significantly different from the responses to total taxes at the same level of confidence.

## **6 Conclusions**

We have investigated the effects of exogenous variations in taxes on a series of macroeconomic variables, with special emphasis on the unemployment rate and the labor market. Our analysis differs from the Romer and Romer (2010) seminal contribution in three main respects: first, in extending their data set of narrative records of exogenous tax innovations; second, in showing that methodological assumptions on both the specification and the estimation of the empirical model are crucial to quantify the size of the tax multipliers; third, in devoting special attention to the labor market implications of the changes in taxes.

We have shown that an increase in tax receipts of one percent of GDP has a sizeable positive impact on the unemployment rate, and a negative impact on hours worked, labor market tightness and job finding probability. The negative effect on GDP is also sizeable, but somewhat in the mid



range of other values found in the literature. We have shown that this depends on a series of methodological details, involving both the econometric specification and the estimation method. We have also shown that the unemployment multiplier of business taxes is larger than the one of personal income taxes, although the former is estimated a bit more imprecisely than the latter.

Obtaining larger unemployment multipliers from business taxes than from personal income taxes poses a series of interesting theoretical challenges. In Monacelli, Perotti and Trigari (2010) we build an RBC model with search and matching frictions to analyze the effects of variations in government purchases. In that model we clarify that changes in government spending affect the hiring rate via variations in the value of non-work relative to work activity, which in turn affects the surplus from the job matching process. Importantly, the relative value of non-work activity captures not only the marginal value of leisure, but broadly the value of all non-market activities, including home production and unemployment benefits.

One can employ the same model to analyze the labor market effects of exogenous changes in a variety of distortionary taxes. For example, variations in wage income taxes would also affect the hiring rate via their effect on the relative value of non-work activity. However, changes in employers' payroll taxes, classified among the business taxes in our empirical analysis, would have exactly the same effect on surplus and hiring. Nash bargaining renders those two taxes effectively undistinguishable in the model. There are several other tax categories that can be modeled within the baseline theoretical framework. For example, we can introduce investment and employment tax credits as directly affecting the cost of hiring a worker (as either a subsidy per vacancy open or a subsidy per new hire). More generally, mapping our tax categories in the data into model counterparts requires some thinking, but the model lends itself easily to this exercise. Further, while there is already extensive work on the steady-state effects of various taxes and subsidies in the baseline Mortensen and Pissarides model, the study of their dynamic effects over the business cycle is quite limited. We plan to explore these issues in future research.

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**Table 1: Tax Multipliers under Alternative Specifications**

	6 qrts	12 qrts	6 qrts	12 qrts	6 qrts	12 qrts
	unemployment rate		job finding prob.		private employment	
OLS R-R one eq. (R-R data)	.32*	1.10*	-1.98*	-4.76*	-.44*	-2.07*
OLS R-R one eq. (our data)	.30*	.67**	-.78	-2.51*	-.59*	-1.35**
OLS augmented R-R	.70**	.74**	-2.56**	-2.09**	-1.13**	-1.22**
OLS F-G	-.05	-.05	.57	.46	-.01	.03
IV M-R	.49*	.54**	-1.79*	-2.17*	-.75**	-.94*
	business wage		private investment		GDP	
OLS R-R one eq. (R-R data)	-.58*	-.51*	-3.56*	-9.69*	-1.17**	-2.74**
OLS R-R one eq. (our data)	.11	.17	-1.63	-3.30	-.82*	-1.73**
OLS augmented R-R	.37	.51	-5.58**	3.01	-1.52**	-1.54**
OLS F-G	.09	.12	-.71	-.84	.34	.35*
IV M-R	.05	.04	-4.67*	-5.11*	-1.15*	-1.10*
<p>Note: * denotes 32% significance level, ** denotes 5% significance level. See Section 4.1 for the details of the alternative specifications.</p>						

**Table 2: Breakdown of taxes**

	Personal	Corporate	Indirect.	Soc. Sec
1.	Tax rates	Tax rates	Indirect taxes	Tax rates
2.	Deductions. allowances	Employment credit		Earnings base
3.	Tax credits	Investment tax credit		Others
4.	Capital gains	Depreciation		
5.	Depreciation	Others		
6.	Earned Income Tax Credit			
7.	Rebates			
8.	Estate and gift			
9.	Others			

**Table 3: Labor and business taxes**

Labor income taxes	Business taxes I	Business taxes II
Personal income	Corporate income	Corporate income
Social security	Capital gains, personal	Capital gains, personal
	Depreciation, personal	Depreciation, personal
		Indirect taxes

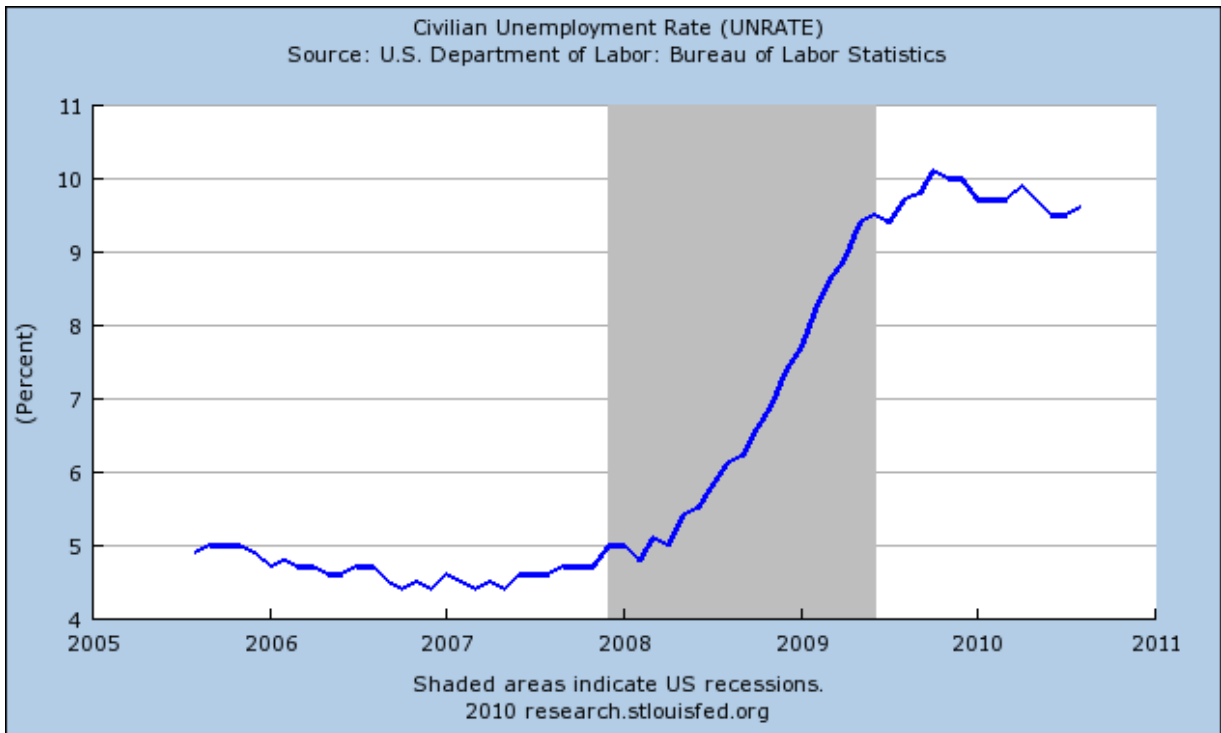


Figure 1. Unemployment Rate in the US

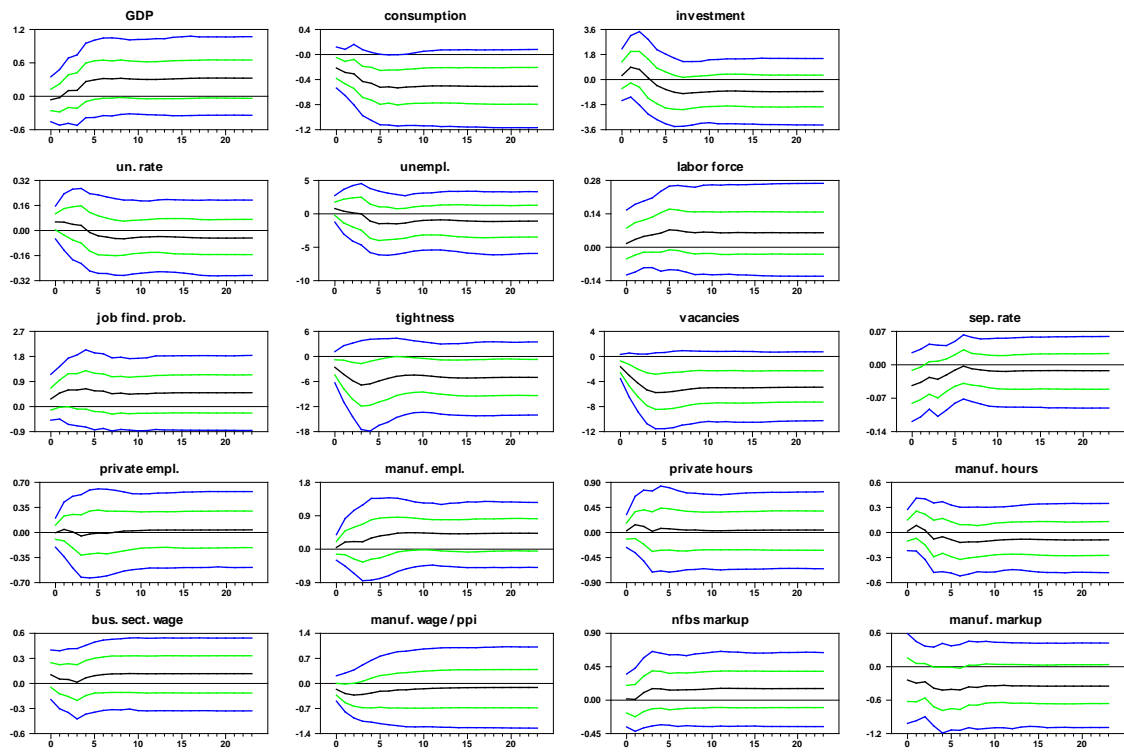


Figure 2. Favero-Giavazzi OLS specification

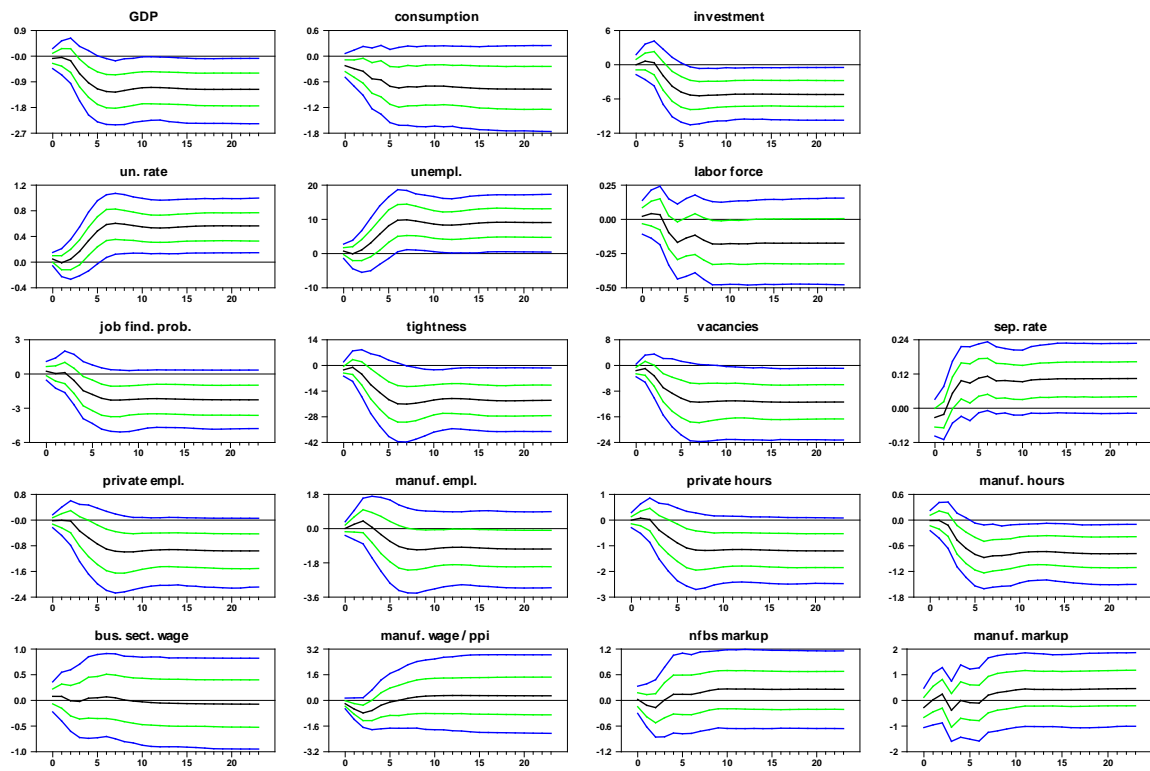


Figure 3. Mertens-Ravn IV specification



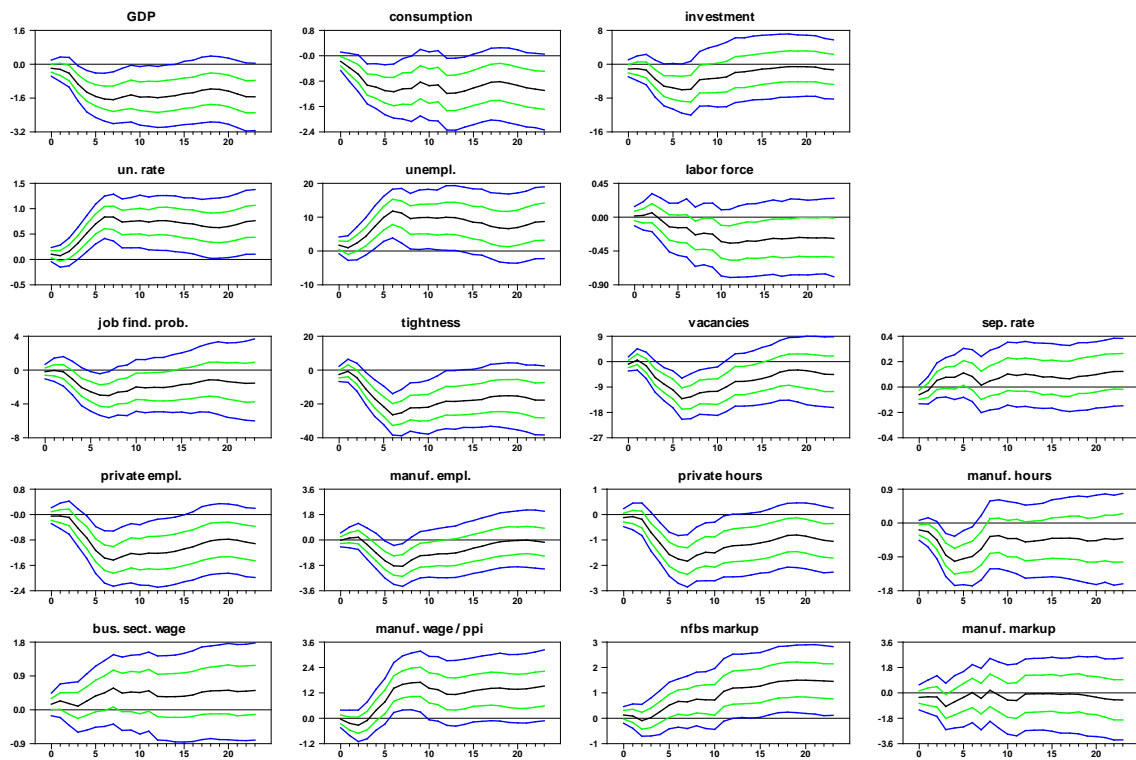


Figure 4. Augmented Romer and Romer OLS specification

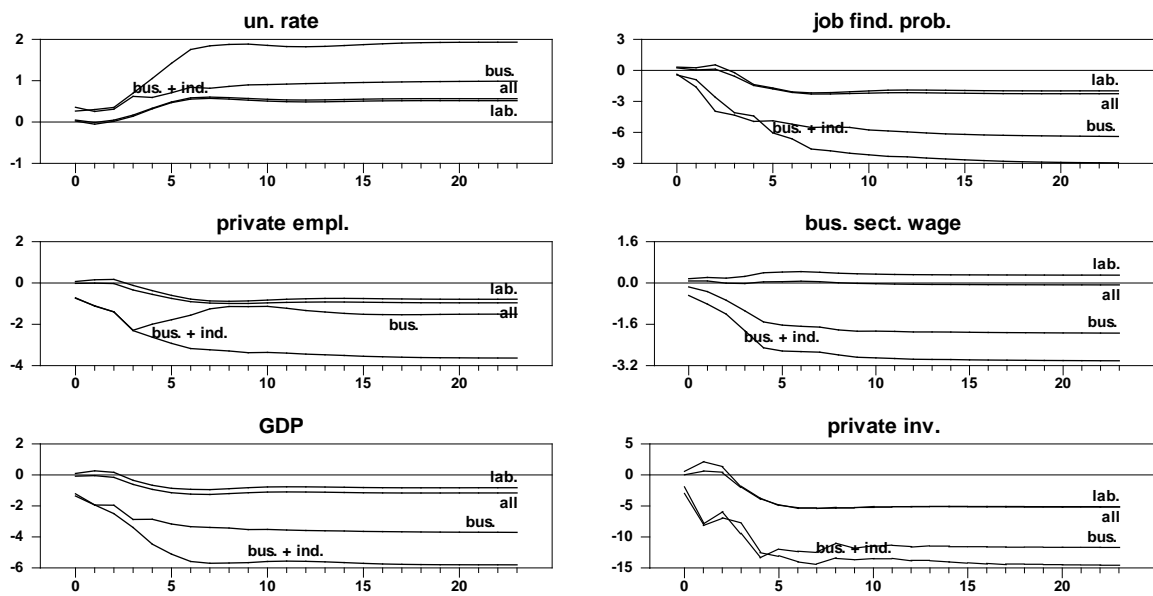


Figure 5. Different types of taxes: Mertens and Ravn IV specification

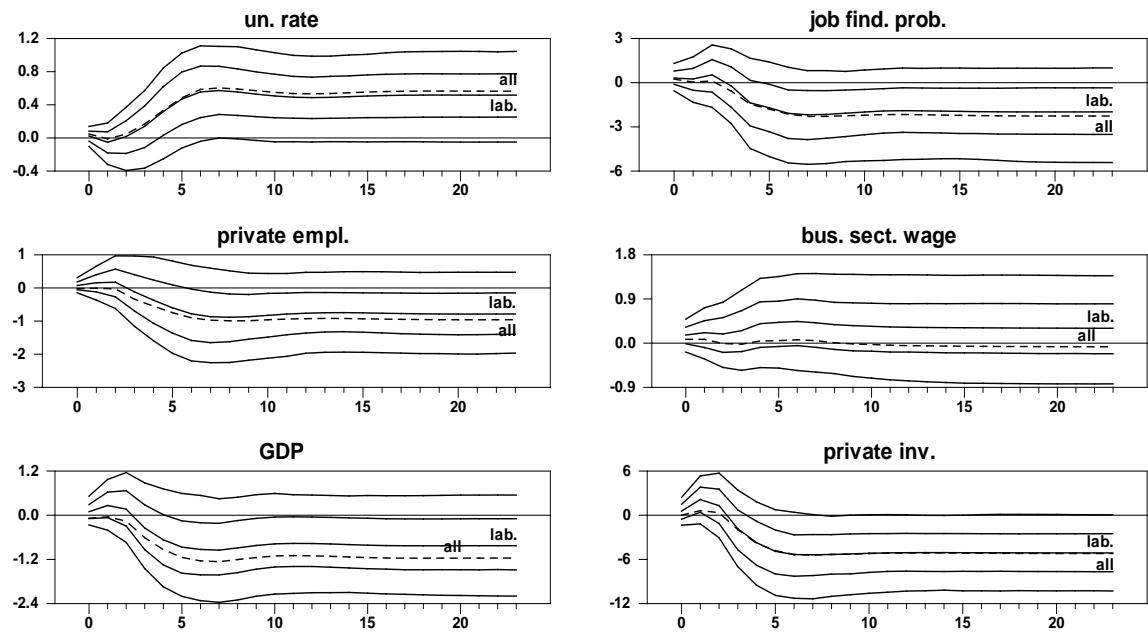


Figure 6. Labor taxes: Mertens and Ravn IV specification

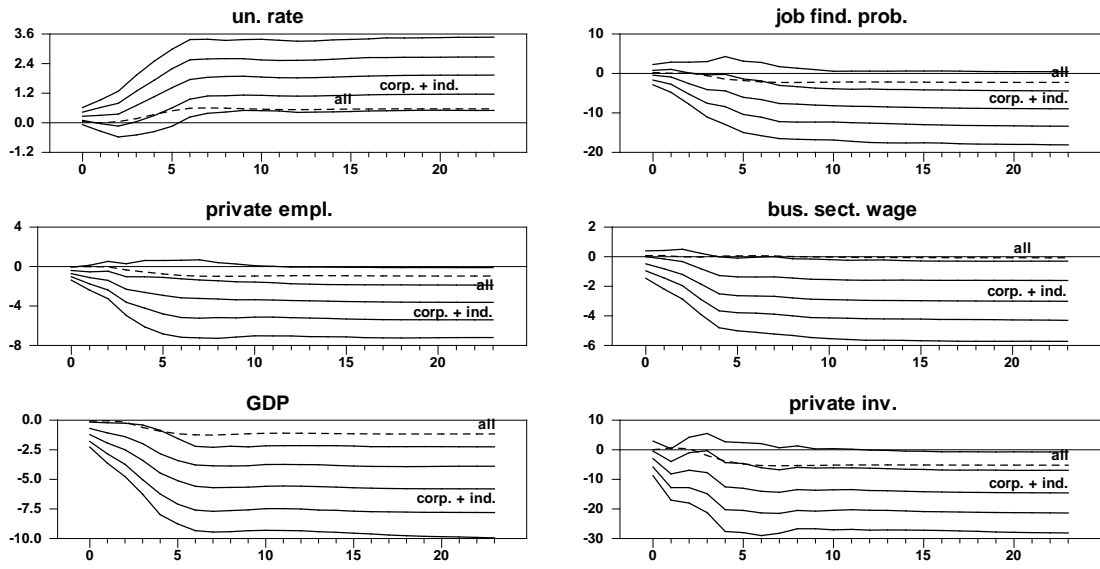


Figure 7. Business taxes: Mertens and Ravn IV specification