State Dependence of Fiscal Multipliers: The Source of Fluctuations Matters

CFM-DP2022-08

Mishel Ghassibe[2] and Francesco Zanetti[1,3]

[1]Centre For Macroeconomics, [2]CREi, [3]University of Oxford

We develop a general theory of state-dependent fiscal multipliers in a framework featuring two empirically relevant frictions: idle capacity and unsatisfied demand. Our key novel finding is that the source of fluctuations determines the cyclicality of multipliers. Policies that stimulate demand, such as government spending, have multipliers that are large in demand-driven recessions, but small and possibly negative in supply-driven downturns. Conversely, policies that boost supply, such as cuts in payroll taxes, are ineffective in demand-driven recessions, but powerful if the downturn is supply-driven. Austerity, implemented by a reduction in government consumption, can be the policy with the largest multiplier in supply-side recessions and demand-driven booms, provided elasticities of labor demand and supply are sufficiently low. We obtain model-free empirical support for our predictions by developing a novel econometric specification that allows to estimate spending and tax multipliers in recessions and expansions, conditional on those being either demand- or supply-driven.