Quarterly Research Alert

Fiscal policy

Alberto Alesina and Silvia Ardagna (2009). Large Changes in Fiscal Policy: Taxes Versus Spending. NBER Working Paper No. 15438. National Bureau of Economic Research.

This paper looks at the effects of large changes in fiscal policy in Canada and 20 other industrialized countries from 1970 to 2007. Specifically, the authors examine the impact that large increases and decreases in government budget deficits have had on both the economy and the national debt. They found that fiscal stimulus initiatives (i.e., large increases in the budget deficit) based on tax cuts are more likely to increase economic growth than those based on government spending increases. The authors also found that contractionary fiscal policy (i.e., large reductions in the budget deficit) based on spending cuts is much more effective than tax hikes for reducing government debt and avoiding economic downturns. In fact, they found several instances where spending cuts used to reduce budget deficits were associated with economic expansions.

—Charles Lammam

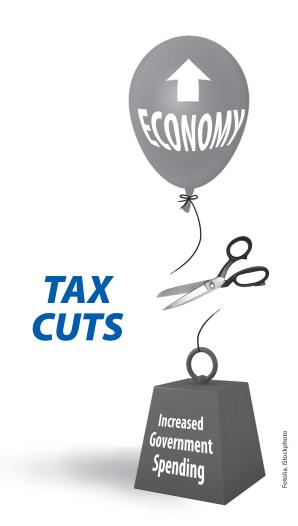
Andrew Mountford and Harald Uhlig (2008). What Are the Effects of Fiscal Policy Shocks? NBER Working Paper No. 14551. National Bureau of Economic Research.

The authors assess and compare the economic impact of various cases of deficit-financed spending, deficit-financed tax cuts, and tax-financed spending in the United States using data from 1955 to 2000. This paper has three major findings. First, deficit-financed tax cuts are the best form of fiscal policy to stimulate the economy. The authors found that a tax cut of one dollar increases GDP by up to five dollars. Second, both deficit-financed and tax-financed spending do not stimulate the economy. Instead, government spending (tax- and deficit-financed) actually discourages private investment, hindering the private sector and the economy generally.

—Alex Gainer and Niels Veldhuis

Christina D. Romer and David H. Romer (2009). The Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks. University of California, Berkley. http://emlab.berkeley.edu/users/dromer/pa- pers/RomerandRomer.pdf>.

This paper examines the impact of tax changes on economic growth in the United States from 1945 to 2007. The authors use narrative records, such as congressional reports and presidential speeches, to identify the timing, motivation, and size of the tax cuts or increases. This method allows the authors to separate and discard tax policy changes made in response to contemporary economic conditions. These policies are removed because the factors affecting this kind of tax change are also related to other developments in the economy. This makes isolating the effects of tax policy difficult. By eliminating



New studies, new ideas

tax changes made in response to current economic conditions, the authors were able to focus only on tax increases that addressed inherited budget deficits and on tax policies intended to achieve some long-term goal (e.g., a smaller role for government, higher economic growth, or increased fairness). The authors found that each dollar of tax cuts increased GDP by approximately three dollars. The reverse was also true: a dollar of tax increases decreased GDP by approximately three dollars.

—Alex Gainer and Niels Veldhuis

Gregory Mankiw, Matthew Weinzierl, and Danny Yagan (2009). Optimal Taxation in Theory and Practice. *Journal of Economic Perspectives* 23, 4: 147–74.

This paper analyzes the relationship between economic tax theory and tax policy. The authors identified eight lessons from tax theory and compared them to actual tax policy in several industrialized countries. While there has been considerable change in both the theory and practice of taxation over the past few decades, the authors found that tax policy has generally moved in the direction suggested by theory in a few areas. For instance, top marginal tax rates—rates on the last dollar of income earned—have fallen, income tax schedules have flattened (i.e., moved toward fewer tax brackets), and taxes on consumption goods and services have become more uniform and are levied on final goods as opposed to intermediate ones. However, capital income continues to be taxed, which is contrary to what theory recommends.

-Milagros Palacios and Charles Lammam

Entrepreneurship

Silvia Ardagna and Annamaria Lusardi (2009). Where Does Regulation Hurt? Evidence from New Businesses Across Countries. NBER Working Paper No. 14747. National Bureau of Economic Research.

Using international data on the individual characteristics of entrepreneurs, the authors investigated the impact of three types of regulation—entry regulation, regulation of contract enforcement, and labour market regulation—on entrepreneurs' decisions to start a new business. They

distinguished between two types of entrepreneurs: those who wanted to pursue a business opportunity (opportunity entrepreneurs) and those who could not find better economic work (necessity entrepreneurs). The authors found that all types of regulation are detrimental to entrepreneurial activity, especially for opportunity entrepreneurs. In fact, entrepreneurs with superior business skills and social networks in heavily regulated countries are less likely to engage in entrepreneurship than those in less regulated countries. The authors found that increased regulation also exacerbates fear of failure, which discourages business start-ups, and that it harms vulnerable groups such as women and the unemployed by pulling them into necessity entrepreneurship. Given these findings, the authors noted that countries can foster entrepreneurship by relaxing regulation.

-Milagros Palacios and Charles Lammam

Poverty and inequality

Maxim Pinkovskiy and Xavier Sala-i-Martin (2009). *Parametric Estimations of the World Distribution of Income*. NBER Working Paper No. 15433. National Bureau of Economic Research.

In this paper, the authors estimate poverty rates and measure income inequality, among other things, for 191 countries for the years 1970 to 2006. They found that global poverty has decreased in the last 36 years for all poverty lines ranging from \$1 per day to \$10 per day. Specifically, at the \$1-per-day line, the poverty rate—that is, the proportion of the population earning \$1 per day or less—declined by 80% from 26.8% to 5.4%. At the \$2-perday line, the poverty rate declined by over 70%. In fact, poverty rates (at the \$1-per-day and \$2-per-day poverty lines) decreased in all regions of the world including Sub-Saharan Africa. The number of individuals living below a poverty line also decreased for most poverty lines considered. For instance, the number of individuals living below the \$1-per-day line declined from 403 million in 1970 to 152 million in 2006. The authors also found that global inequality decreased (regardless of the measure used) and that most global inequality is due to betweencountry, as opposed to within-country, inequality.

—Amela Karabegović