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Abstract

We estimate the effects of government spending (G) on GDP in Canada using the sign restricted VAR approach with quarterly data that spans from 1961 to 2019. The variables that enter our vector autoregressive model are carefully chosen to reflect the distinct characteristics of the Canadian economy, in particular, its linkages with US business cycles. We find large median multipliers that are above 1 on impact and in the long-run. They are not specific to the state of the economy. Moreover, neither net exports nor real exchange rates nor terms-of-trade respond significantly to G shocks. We also find large and long-lasting effects of shocks specific to government spending in investment and in consumption on output.

JEL identification: E32, E62, C51

Keywords: government spending multipliers, sign restricted VARs, Canadian economy

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1 Introduction

How do Canadians benefit from an additional dollar in spending by their governments? Macroeconomists measure the aggregate effects of public spending by estimating government spending (G) multipliers. While the literature on the US G multipliers is abundant, it is limited for its Canadian counterpart. In this paper, we fill this gap in the literature by estimating sign restricted SVARs based on Canadian quarterly data that spans from 1961 to 2019. We find multipliers that are consistently greater than one on impact, and over a horizon of 30 quarters after the shock. In fact, no matter what specification of government expenditures we use, whether it is total G , G in consumption (G_C), or in investment (G_I), and no matter whether the economy is in expansion or recession; a multiplier of size one is just too small to make the cut. By contrast, in her summary of the current state of knowledge for developed economies, [Ramey \(2019\)](#) explicitly suggests that one is the upper bound of G multipliers.¹ Our baseline estimates would have also certainly been puzzling for the late Canadian economist and Nobel laureate Robert Mundell. In fact, one of the main predictions of the Mundell-Fleming model is that, *all else equal*, a greater share of imports in GDP implies a smaller G multiplier.² We find that imports increase following a positive G shock; however, exports concurrently increase by about the same size, which disqualifies international trade as a primary factor to explaining the size of G multipliers.

The system of equations that we estimate is a VARX model, where X stands for exogenous variables. We use the sign restrictions methodology whose earliest contributions on monetary policy include [Faust \(1998\)](#), [Canova and De Nicrolo \(2002\)](#), and [Uhlig \(2005\)](#). [Mountford and Uhlig \(2009\)](#) apply these methods to investigate the effects of fiscal policy in the United States. The restrictions that we implement to identify the effects of G shocks are minimal: real GDP must

¹[Ramey \(2019\)](#) reports a lower bound of 0.6 for developed countries.

²This result is due to net exports being crowded-out following a positive G shock. In contrast, we do not find that net exports respond significantly to G shocks. Therefore, as confirmed by our estimations, the large multipliers are related to the crowding-in of private consumption and investment.

respond positively to a positive G shock. Since we are imposing a restriction on the sign of real GDP, we are not completely agnostic; however, we apply Uhlig's (2017) first principle on sign restrictions: *If you know it, impose it!* We believe that there is sufficient evidence in the literature for positive G multipliers on impact. First, this is simply the outcome of the vast majority of RBC and New Keynesian models that feature temporary G shocks. Second, in her review of the state of knowledge, Ramey (2011) asserts that 0.5 is the lower bound for which reasonable people are not contradicted by the data. Third, from data on G multipliers gathered by Gechert (2015) from 104 papers that use a variety of approaches, less than 3% (5 out of 176) feature negative G multipliers on impact.³ Therefore, given the empirical evidence on the size of G multiplier, imposing that it only takes positive values on impact is a mild restriction. The main investigation in the literature is around the magnitude of the multiplier above or below 1.

A competing approach that is widely used in the literature is the one put forward by Blanchard and Perotti (2002). Their identification strategy relies on ordering G first in a structural VAR, and in extracting the structural shocks using a Cholesky decomposition. They justify this ordering choice by arguing that there are decision and implementation lags that prevent G from reacting to changes in real GDP and in other variables within a quarter. While this approach is well-suited for the US, we question its appropriateness for Canada. The reason is that Canadian business cycles lag those of the US, which invalidates the exogenous character of G . Specifically, the cross-correlation of the cyclical components of Canadian GDP at quarter $t + j$ and US GDP at quarter t are 0.6, 0.74, and 0.76 for $j = \{-1, 0, 1\}$, respectively.⁴ In light of this data property, it is reasonable to presume that a significant part of Canadian G is reacting to developments that take place in the US economy, and, therefore, its fluctuations are not exogenously driven. For this reason, the sign restrictions approach is more suitable in the Canadian context.

³Moreover, three out of five of these negative values are coming from the same paper, *i.e.* Fatás and Mihov (2001).

⁴These correlations are based on quarterly real GDP data that spans from 1961 to 2019. As is standard in the literature, this corresponds to the largest correlation (in absolute value) of the cross-correlation function between the two countries' HP-filtered ($\lambda = 1, 600$) real GDP in logs. The degree of synchronization of economic activity between Canada and the United States is also high throughout all the sample that we use for the estimations.

Since our focus in this paper is solely on Canada, the estimates of the multipliers are the byproducts of specific Canadian characteristics. Our results are also informative for other small-open economies more generally. Our reasoning is the following. As discussed in the previous paragraph, the major challenge in identifying G shocks is that these shocks are entangled with business cycle shocks. Based on the cross-correlation function of output between Canada and the US, it is safe to say that variations in the US economic activity drive variations in Canadian GDP that are not related to government spending—or at least there are many common factors affecting both of these countries simultaneously. Therefore, by having the US GDP as an exogenous variable to our model, we are effectively controlling for a large share of business cycle shocks.⁵ Since of the largest cross-country correlations in real GDP between the US and other OECD countries is with Canada, our identification strategy is more precise than that of estimating other countries' G multipliers.⁶

One way to gauge the importance of controlling for US GDP in the analysis is simply to remove it as an exogenous variable from the baseline model and compare the G multipliers that we obtain. We find a substantially larger G multiplier when US GDP is excluded.⁷ It is one unit larger at the peak of the (median) impulse response which occurs around 10 quarters after the G shock. The importance of considering the US GDP is further reinforced by the findings of [Faccini, Mumtaz, and Surico \(2016\)](#) and [Ilori, Paez-Farrell, and Thoenissen \(2022\)](#) whose estimations reveal large positive transmission effects of US government spending on Canadian GDP.

We complement our main finding that Canadian G multipliers are large with related results.

⁵To relate to a concept emphasized by [Caldara and Kamps \(2017\)](#), fiscal policy has indeed a systematic component in our estimations—economic activity in the US feeds back to Canadian G contemporaneously. We cannot impose that the latter variable responds negatively to a Canadian business cycle shock, because there would be conflicting sign restrictions as we already impose a positive sign on the response of GDP to a G shock.

⁶[Ambler, Cardia, and Zimmermann \(2004\)](#) find that the correlation is the largest for Canada using HP-filtered quarterly data that spans from 1960Q1 to 2000Q4.

⁷This finding is specific to the sign restriction approach. In contrast, the G multiplier falls significantly when the US GDP is removed as an exogenous variable in the context of the Blanchard-Perotti setup. These results are available upon request to the authors.

First, we re-estimate the baseline model by allowing for differences in responses for two regimes: recessions and expansions, which are set prior to the estimation, in similar fashion to [Auerbach and Gorodnichenko \(2013\)](#). Specifically, the regimes are determined by a threshold on a detrended moving average growth rate of real GDP. We find large G multipliers over all phases of the Canadian business cycle, not solely in recessions. This result has important implications for policy-makers in Canada as it suggests that public spending during booms remains as effective as in recessions. Second, we examine the implications of G shocks for labour productivity and TFP. We find that the median responses of these two variables are almost as high as the response of output in the short-run. Third, we decompose G into its consumption (G_C) and investment (G_I) components. To sharpen our identification strategy for shocks to these two components, we add the labour share—total labour compensation over total income—to the baseline model, and impose additional sign restrictions on their responses. These restrictions are in line with the two characteristics of the Canadian economy mentioned above. Specifically, given that the labour intensity of Canadian G_C goods and services is greater than that of private goods, we impose that the labour share increases on impact in response to positive G_C shocks. Conversely, we assume that it decreases on impact in response to positive G_I shocks, since the income generated by this category of spending accrues proportionally more to the owners of capital than to workers. To briefly summarize our results related to the decomposition of G , we find long-lasting effects of both types of shocks on output—cumulative multipliers exceed unity for all time-periods over a horizon of 30 quarters.

The rest of the paper is organized as follows. In section [2](#), we discuss previous work that provides specific point-estimates of the Canadian G multiplier. In section [3](#), we describe the data and summarize the sign restriction methodology. Section [4](#) presents the main empirical results of large G multipliers. Finally, section [5](#) concludes.

2 Related literature

The literature on fiscal multipliers is too vast to be reviewed in this section; hence, we focus our attention on work that employ Canadian data. First, we review research based on panel methods for which Canada is featured in the sample. [Ilzetki, Mendoza, and Végh \(2013\)](#) estimate a panel VAR model and rely on [Blanchard and Perotti's \(2002\)](#) approach to identify the shocks to G_C for 20 high-income countries and 24 developing countries. They find multipliers of 0.39 and 0.66, on impact and in the long run, respectively. The multipliers that we find for Canada are above the 90% confidence intervals for all the horizons that they plot. Other interesting results concern the sensitivity of multipliers to trade openness. Specifically, the authors split countries into two groups based on whether the sum of their exports and imports over GDP is below or above 60% on average.⁸ The multipliers for the group of countries that they consider "open" are even smaller—*i.e.* -0.08 and -0.46 on impact and in the long run, respectively. This finding is consistent with the Mundell-Fleming model; however, in the absence of impulse responses for net exports, we do not know if it is the crowding-out of this variable that indeed drives their estimated multipliers as in the theory.

Using more recent panel data (1995:Q1-2016:Q4) and estimating G shocks à la [Blanchard and Perotti \(2002\)](#), [Priftis and Zimic \(2021\)](#) find G_C multipliers that exceed one at a 12-quarter horizon.⁹ [Auerbach and Gorodnichenko \(2013\)](#) also estimate G multipliers from panel regressions. They examine the effects of G shocks, which consist of semi-annual forecast errors of growth rates in G of OECD countries, by running local projections. As mentioned above, they find asymmetric G multipliers; specifically, positive multipliers during recessions, but negative during expansions.

There is also a literature that investigates the international dimensions of fiscal policy and

⁸Somewhat oddly, with a ratio of 54.8%, Canada falls short of making the 'open' economy cutoff used in [Ilzetki, Mendoza, and Végh \(2013\)](#).

⁹Their main result is that fiscal multipliers are larger when public debt is financed by foreigners instead of residents.

their effects on exchange rates. Given that the Canadian dollar has been floating since 1970, it is often featured in this strand of the literature. [Corsetti and Müller \(2006\)](#) and [Monacelli and Perotti \(2010\)](#) identify G shocks using [Blanchard and Perotti's \(2002\)](#) approach in structural VARs. In both papers, the responses of output are not significantly different from zero, as the lower one-standard error confidence bound stands in negative territory.¹⁰ The net exports-to-GDP ratio also falls for both of them. For [Corsetti and Müller \(2006\)](#), the response of this variable is significant at the one and three year-mark—the only horizons that they report—while [Monacelli and Perotti \(2010\)](#) find that the fall is only significant after one and two quarters. Therefore, there is some evidence of crowding-out that originates from international trade as emphasized by the Mundell-Fleming model. As for the responses of relative prices, both of these studies find that they are not significant for terms-of-trade nor real exchange rates.

[Ilori, Paez-Farrell, and Thoenissen \(2022\)](#) also order G —precisely, G_C —first in the VAR as advocated by [Blanchard and Perotti \(2002\)](#); however, they use Bayesian VAR methods. They find some crowding-out effects of investment and net exports for Canada, yet consumption responds positively to a positive G_C shock. The negative effects on net exports do not seem to be driven by the responses of relative international prices as both the terms of trade and the real exchange rate depreciate. Finally, the response of real GDP suggests a positive but very small G_C multiplier. The shape of this response would also be very difficult to reconcile with economic theory, as it is positive on impact, falls to zero 3 to 5 quarters after the shock, and goes back up before starting to plateau after 10 quarters. Moreover, they do not control for US GDP, which, as we have argued, can have much influence on the size and persistence of the G multipliers that they find.

Based on an innovative methodology that involves using the conditional heteroscedasticity of the structural shocks to identify G shocks in the context of VARs, [Bouakez, Chihi, and Normandin \(2014\)](#) find that the Canadian dollar appreciates following a positive G shock—significantly for

¹⁰Over a horizon of 20 quarters, the responses reported by [Monacelli and Perotti \(2010\)](#) are even always negative.

about three years after the shock though. Another interesting result that they report for Canada is that the decline in the current account over a horizon of one year is significant. The time periods, variables, and identification strategies differ from ours in these previously discussed four studies, which can explain why our results diverge. In fact, our findings show no role for international quantity nor price variables in explaining G multipliers even though Canada is a small open economy.

[Cacciatore and Traum's \(2020\)](#) results also run against the majority of empirical and theoretical findings in the literature, as they challenge some of the Mundell-Fleming model's predictions. Specifically, they show that openness to trade can contribute to larger G multipliers. Their two-country new Keynesian model features Canadian and US data and is estimated using Bayesian methods. Based on an analytical development, they emphasize the appreciation of terms of consumption to a positive G shock as the main channel behind larger G multipliers. They define terms of consumption as the relative price of domestic to imported goods, which, as they explain, corresponds to terms of trade under the assumption of complete exchange rate pass-through. In their model, exchange rate pass-through is incomplete, yet they show that terms of trade also respond positively given their posterior estimates. In contrast, as mentioned in the previous paragraph, our results do not confer any role to terms of trade, no matter the horizon.

[Owyang, Ramey, and Zubairy \(2013\)](#) and [Hussain and Liu \(2023\)](#) rely on narrative methods to estimate Canadian G -multipliers. [Owyang, Ramey, and Zubairy \(2013\)](#) find larger multipliers when the Canadian economy experiences high versus low unemployment spells—two years after the shock they report 1.6 and 0.44, respectively. Their identification strategy relies on news of military spending which are mainly centered around two events: WWII and the Korean war. Moreover, the changes in regimes, which rely on the unemployment rates, are far from being cyclical for Canada, in contrast to the US. For example, all the time period that spans from the mid-1970s to the mid-2000s is considered as a period of slack by the authors. Our results differ from those

of these two studies, as the multipliers that we find are consistently high during expansions and recessions. [Hussain and Liu \(2023\)](#) identify exogenous changes in G from budget speeches, and find a cumulative multiplier of 1.48 at a 2-year horizon. However, they report that the predictive power of the news variable that they construct falls significantly once they remove the Korean war period. To overcome this problem, they construct another news variable which consists in G that are announced and implemented in the same year. Based on this variable on data that starts in 1984Q2, the G multipliers drops to 0.73 when it is evaluated at its peak response. Note that [Hussain and Liu \(2023\)](#) also compare the multipliers that they obtain from various narrative approaches to multipliers estimated from a structural VAR for which G is ordered first. At a 2-year horizon, they find a G -multiplier of 0.55.

[Pappa \(2009\)](#) uses the sign restriction methodology for Canada, among other countries, with data that spans from 1970 to 2007. As for the restrictions that she imposes, they consist of positive responses on output and on the primary budget deficit on impact. Nine variables are included in her model and some of them differ from the ones that we select. Twelve quarters after the shocks, she finds cumulative multipliers of G_C and G_I of 1.02 and 0.61, respectively, which are significantly lower than the ones we find. We suspect that one reason that can explain such discrepancy is that she removes wage expenditures from her definition of G_C . Another reason might be that she does not control for the other category of G when estimating the effects of a particular category of G . Specifically, she excludes G_I from her model when the shock is to G_C , and vice versa.

Finally, [Azad, Serletis, and Xu \(2021\)](#) also estimate the effects of G using the sign restriction methodology for Canada, and following very closely [Mountford and Uhlig's \(2009\)](#) approach. The authors do not present the G multipliers that they obtain; however, we suspect that, based on their median responses, they must be close to zero for the first year and negative further on. Their results are far away from ours, since we use different methodologies and data. Some of the different aspects on the methodological side are the following: (i) they first identify a business

cycle shock that is orthogonal to other shocks, (ii) they do not impose any sign restriction on the response of GDP following a G shock, (iii) their estimators are based on a penalty function which implies that they also consider models that come close to satisfying the restrictions. On the second aspect, we reiterate that the restriction that we impose on the response of GDP is consistent with the simulation results of the great majority of RBC and New Keynesian models. On the third aspect, we use pure sign restrictions which we deem more suitable than the penalty function in light of various critiques that it has received (Arias, Rubio-Ramirez, and Waggoner 2018, Caldara and Kamps 2017). Finally, their data spans from 1990Q1 to 2020Q4, which comprises the Great Lockdown. Given the large variations in macroeconomic variables that occurred during this period, it is unclear what their effects are on their VAR estimates.

3 Data and Methodology

In this section we provide details of the data used in the analysis followed by a description of the methodology.

3.1 Data

Table 1: Endogenous and exogenous variables used in the baseline model

Endogenous (Canadian)	Exogenous
GDP (GDP)	US real GDP (X)
Government expenditures (G)	
Government revenues (T)	
Real interest rate (r)	
Real exchange rate ($REER$)	

Notes: We construct real Canadian quantity variables by dividing the nominal series (GDP and government expenditures and revenues) by the GDP deflator. As for the real interest rate, we subtract the one-quarter ahead inflation rate (annualized growth rate of the GDP deflator) that is observed ex-post from the nominal interest rate. The real exchange rate corresponds to the ratio of the US and Canadian GDP deflators multiplied by the nominal exchange rate between the Canadian and US dollars. Hence, an increase (decrease) in this variable corresponds to a depreciation (appreciation).

The data that we use goes back in time as far as possible—for Canadian expenditure-based data this corresponds to the first quarter of 1961—and ends in the fourth quarter of 2019. The baseline specification features five endogenous variables and one exogenous variable which are listed in Table 1. Note that transfer payments are not included in G . We provide a detailed description of these variables in Table 4 of Appendix A. We apply the logarithms to all variables, except to the real interest rate. We include US GDP given both countries’ high degree of synchronization of economic activity, that is also captured by the adage: “when the US sneezes, Canada catches a cold”.¹¹ The reverse, however, is not true, since Canadian business cycle lags that of the US, hence, the exogenous role of US GDP in the models that we estimate.

3.2 Methodology

Our analysis is based on the VARX(2) model

$$y_t = A_1 y_{t-1} + A_2 y_{t-2} + C_1 X_t + u_t, \quad (1)$$

where y_t is a 5×1 vector of endogenous variables (GDP , G , T , r and RER) and X_t denotes real US GDP. We choose the lag order based on the AIC. The model also includes vectors of constants and time trends which are suppressed from equation (1) to simplify notation. A_1 and A_2 are 5×5 matrices of coefficients and C_1 is a 5×1 vector. Finally, u_t is assumed to be an *iid* sequence of 5×1 random vectors such that $E(u_t) = 0$ and $E(u_t u_t^\top) = \Sigma_u$, where Σ_u is a positive definite non-random matrix. This reduced-form VARX model corresponds to the linear structural model

$$B_0 y_t = B_1 y_{t-1} + B_2 y_{t-2} + D_1 X_t + \varepsilon_t, \quad (2)$$

¹¹It is also true during good times—a healthy US economy gives rise to sunny ways for the Canadian economy.

Table 2: The sign restrictions

	GDP response	G response	T response	r response	RER response
G shock	+	+	*	*	*
r shock	—	*	*	+	*
T shock	—	*	+	*	*
shock 4	*	*	*	*	*
shock 5	*	*	*	*	*

Notes: All the sign restrictions are imposed at horizon 0 only. The * denote the absence of a restriction on this specific combination of shock and response.

where the structural coefficient matrices B_0 , B_1 , B_2 and D_1 are related to the reduced-form matrices A_1 , A_2 and C_1 as $A_1 = B_0^{-1}B_1$, $A_2 = B_0^{-1}B_2$ and $C_1 = B_0^{-1}D_1$. The 5×1 vector ε_t contains structural shocks which are assumed to have unit variance and to be orthogonal.

We use sign restrictions to identify three policy relevant shocks: a government expenditure shock (G shock), a government revenue shock (T shock) and a monetary policy shock (r shock). The other two shocks are left unidentified and may therefore be considered as “residual” shocks from sources other than fiscal and monetary policy that affect the variables in the model. The fiscal and monetary policy shocks are identified through a set of sign restrictions on some elements of the impact matrix B_0 .

The impact sign restrictions are summarized in Table 2. A positive G shock is defined as one which has a positive contemporaneous impact on both GDP and G while having an unspecified impact on the other three variables. Notice that imposing a positive immediate impact of G on GDP does not imply that the multiplier is positive over time since we impose no restrictions on the response of GDP for future quarters after the shock. Thus, for example, our model does not exclude the possibility of a crowding-out effect of private investment and consumption developing over time following the G shock. Even though we are only interested in measuring the size of the G multiplier, we use sign restrictions to identify government revenue and monetary shocks (the reasons for this is discussed below). A positive revenue shock is defined as having an immediate

positive impact on T and a negative impact on GDP. The monetary shock is defined as having a positive impact on r and a negative impact on GDP.

are set-identified. This means they allow researchers to obtain a set of structural models coherent with the observed data as expressed through the reduced form VARX model (1), and satisfying the specified sign restrictions. This set of structural models is approximated by numerical simulations, see Appendix B for a description of the algorithm used in this paper.

We construct the structural impulse responses from these admissible structural models and compute G multipliers. Consequently, we obtain a set of impulse responses and multipliers that have a structural interpretation because they result from a shock that exhibits the patterns of responses that serve as the basis to our identification strategy. Because we are interested only in the G multiplier (and impulse responses to a G shock), it may seem useless, if not counter-productive, to impose identifying restrictions for the T and monetary shocks.¹² There are, however, at least two reasons why this is not so.

The first is that these extra identifying restrictions serve to reduce the size of the set of admissible structural models, and therefore provide sharper approximations for our impulse responses and multipliers. The second reason is to reduce what Fry and Pagan (2011) call the “multiple shock problem”. This problem results from the possibility that one or several unidentified “residual” shocks could exhibit the same pattern of response as the identified G shock. If this were to happen, the response of both the G shock and the unidentified shock could be interpreted as a response to unexpected government expenditure, which would obviously compromise of our inferences. To put it differently, the decision to include the response to the identified G shock in our admissible set and not the response to the unidentified shock would be completely arbitrary and may confound inference. The identification of the tax revenue and monetary shocks with sign restrictions differ-

¹²For example, Uhlig (2005) studies the impact of monetary policy shocks and identifies only a monetary shock, leaving the other four shocks of his model unidentified.

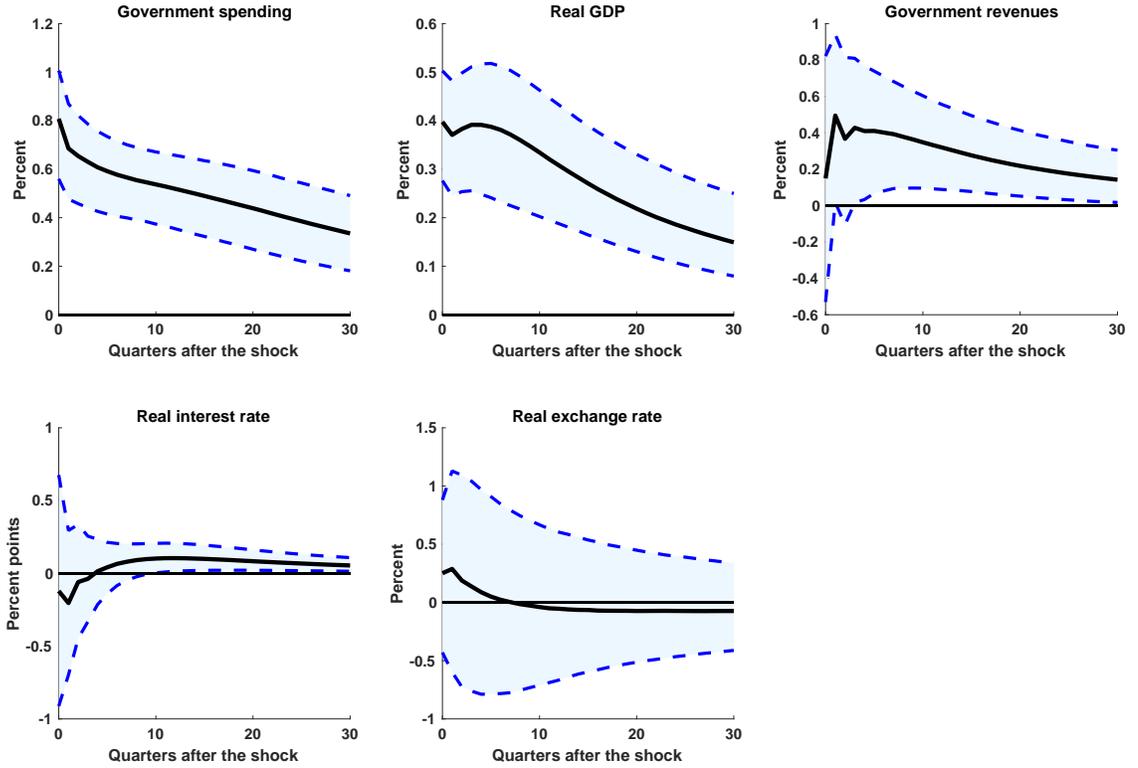
ent from those of an expenditure shock, means that only two, rather than four, unidentified shocks remain in our model. This obviously reduces the probability of encountering the “multiple shock problem”.

As most papers using sign-identified models, we conduct inferences on the results of our model using Bayesian methods to estimate the posterior distribution of the impulse responses. See Appendix B for details. Finally, Section 4 investigates the possibility that the government expenditure multiplier may differ when the shock occurs in a recession or an expansion. We implement this analysis with a regime switching threshold VAR version of model (1) similar to that of Auerbach and Gorodnichenko (2012) but with the sign restrictions described above imposed to achieve identification (see Appendix C for more details).

4 Results

Figure 1 plots the impulse responses of the five endogenous variables comprised in the linear VARX to a one standard deviation shock to G . A first observation is that the G shock itself and the response of real GDP are persistent, since the lower bound of their credible sets are always in positive territory. As a reminder, the restrictions that we impose are only on impact, *i.e.* at period 0, so the persistence is not an artifact of these restrictions. The median response of government revenues increases following a positive G shock—the 16th percentile however lies in negative territory on impact. This is probably related to the positive impact on GDP, as greater economic activity goes hand in hand with greater tax revenues. Moreover, based on the fact that credible sets of the real interest and real exchange rates lie in both positive and negative territories, we infer that monetary policy and international prices dynamics do not interfere with the G multipliers that we find. The signs of these initial responses are also at odds with the predictions of the textbook Mundell-Fleming model with flexible exchange rates. According to this model, the real interest rate should increase and the exchange rate appreciate.

Figure 1: The impulse responses to a one standard deviation shock to government expenditures



Note: These responses are obtained from the estimation of the VARX model described in the previous section. The black solid lines correspond to the median responses, while the dashed blue lines are the 16th and 84th percentiles.

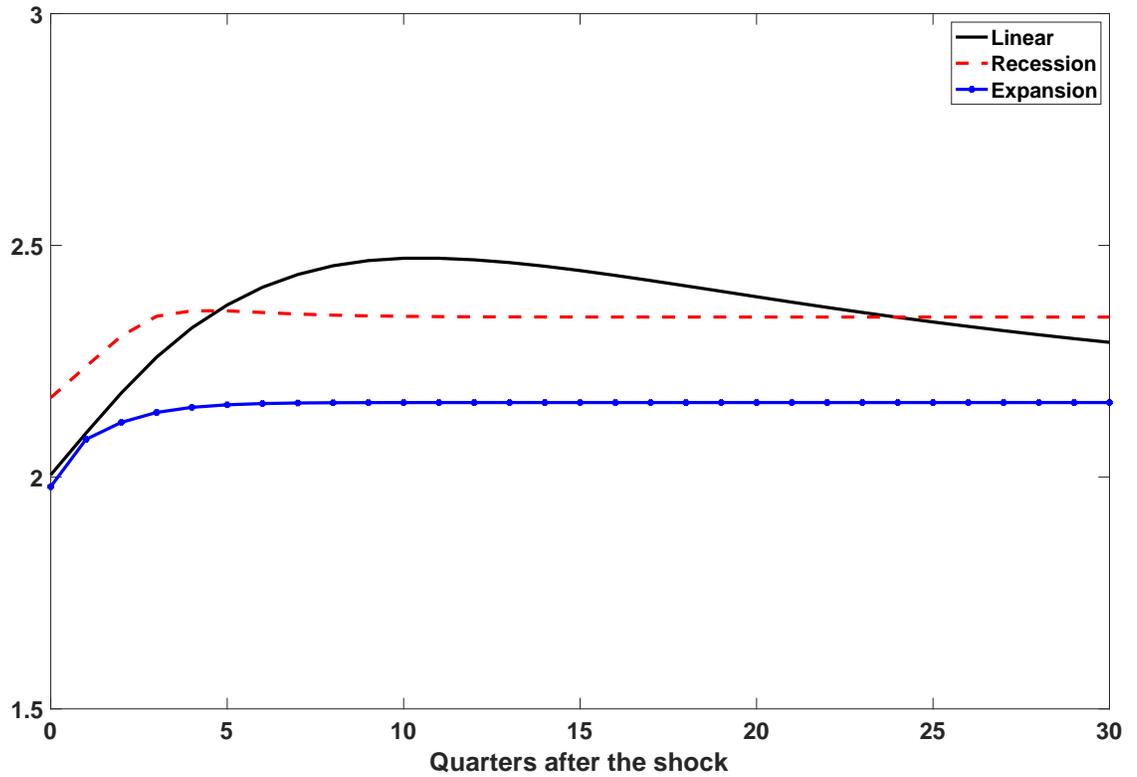
In Figure 2, we compare the cumulative G multipliers at different horizons (h) obtained for the baseline and non-linear (expansion vs. recession regimes) models.¹³ We follow the standard approach in the literature to construct the multipliers as:

$$CM_G(h) = \frac{\sum_{j=0}^h (1 + \bar{r})^{-j} Y_{Gj} \bar{Y}}{\sum_{j=0}^h (1 + \bar{r})^{-j} G_{Gj} \bar{G}} \quad (3)$$

where $\bar{r} = 1.61\%$ that is the average value of the real interest rate in our sample. The summations

¹³Since the responses obtained from the estimation of the non-linear model are similar to the ones shown for the baseline model, we do not present them.

Figure 2: The cumulative multipliers of the linear and the two-regime models



Note: See equation (3) for the details on the construction of these multipliers.

correspond to the net present values of the median responses of GDP and G to G shocks: Y_G and G_G , respectively. Finally, \bar{Y} and \bar{G} are the average values of GDP and G , respectively, in the sample.¹⁴

There are two important results that Figure 2 conveys. First, just visually it is evident that the G multipliers are not sensitive to the state of the economy. The literature on the US G multipliers is split between work that find evidence of state dependency, led by [Auerbach and Gorodnichenko \(2012, 2013\)](#), and others that reject it, led by [Ramey and Zubairy \(2018\)](#). Our results show that the

¹⁴Note that we use median responses to construct the multipliers. The size and shape of these multipliers are not significantly different from median multipliers based on the set of sign-identified models.

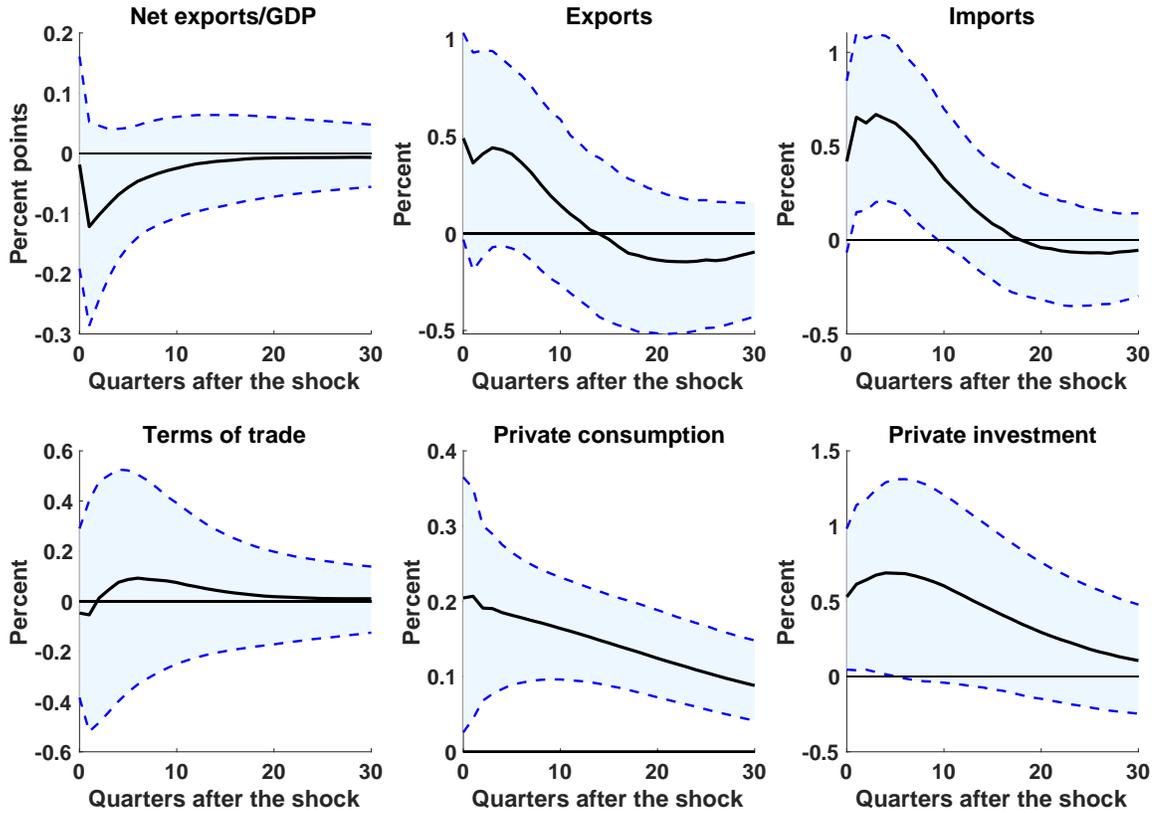
evidence speaks with one voice in Canada and supports no state dependency in the size of the G multiplier. The second finding is about the scale of multipliers that we find: they are large and very persistent. On the size of the G multiplier, [Ramey \(2019\)](#) claims that “the bulk of the estimates across the leading methods of estimation and samples lie in a surprisingly narrow range of 0.6 to 1.” Based on a meta-analysis, however, [Gechert \(2015\)](#) does not find such a narrow range—the upper bound for the G multipliers (one standard deviation over the mean) lie around 1.5 for a horizon between 0 to 8 years after the shock. The G multipliers that we find are certainly not the largest ever reported in the literature, but they could be in the top 5% of the estimates. They are comparable to the multipliers found by [Auerbach and Gorodnichenko \(2012\)](#) for the US in recessions only. Such large magnitudes once again do not support the predictions of the Mundell-Fleming model that a small open economy (like Canada) should have lower G multipliers than countries with smaller trade openness, such as the US.

We have already shown that the real exchange rate does not respond much to G shocks. Is it also the case for other international variables? To avoid overloading the models that we estimate, we add five different set of variables, each in turn, to the baseline model: i) net exports over GDP, ii) exports, iii) imports, iv) terms of trade,¹⁵ and v) private consumption and investment. Since the impulse responses of the five original endogenous variables are similar to the ones displayed in [Figure 1](#), we only present the responses of the new variables in [Figure 3](#).

The majority of theoretical models predict a fall in net exports, which is what we find; however, the upper bound of the credible set is always in positive territory, and even the median response is too small to have significant effects on the multipliers. This result contrasts with the findings of [Corsetti and Müller \(2006\)](#) and [Monacelli and Perotti \(2010\)](#), as they find larger trade deficits following positive G shocks in Canada. Even though net exports are relatively stable following G shocks, trade is rising; specifically, exports and imports are increasing by the same margins. The

¹⁵We define terms of trade as the price ratio of imports over exports.

Figure 3: Additional responses to G shocks from variants of the baseline model

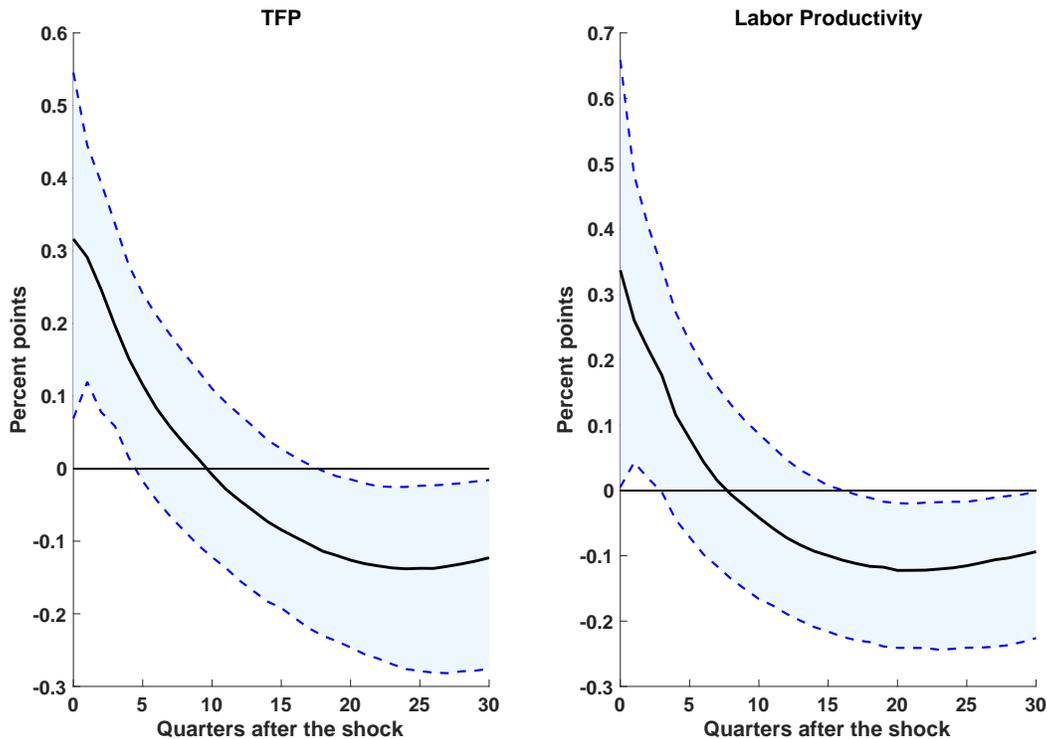


Notes: These responses are obtained from the estimation of four different configurations of the augmented baseline model as described in the text. The black solid lines correspond to the median responses, while the dashed blue lines are the 16th and 84th percentiles.

increase in imports is consistent with the predictions of the Mundell-Fleming model, as some of the additional income generated by G shocks is spent on foreign goods. On the other hand, this model is silent on the dynamics of exports as it assumes that they are driven by foreign variables. Given the responses of net exports, it is very unlikely that trade is playing a key role to explaining the large G multipliers in Canada that we find.

As for international relative prices, we find that the median response of terms of trade is very close from being muted. This evidence goes against the transmission channel that [Cacciatore](#)

Figure 4: The responses of labour and total factor productivities to G shocks



Notes: These responses are obtained from the estimation of four different configurations of the augmented baseline model as described in the text (1976Q1-2018Q3). The black solid lines correspond to the median responses, while the dashed blue lines are the 16th and 84th percentiles.

and Traum (2020) emphasize—*i.e.*, based on their posterior estimates, an increase in Canadian G leads to an appreciation of terms of consumption and terms of trade, and thereby amplifies the G multiplier.¹⁶ Finally, we infer from the responses of private consumption and investment, that there is no evidence of crowding-out—as it is often the outcome of theoretical model. The findings displayed in Figure 3 suggest that the investigation of factors that contribute to G multipliers should focus on closed-economy dimensions.

¹⁶The authors estimate their structural two-country model with Bayesian methods. They define terms of consumption in footnote 3 of their paper as follows: “With incomplete exchange rate pass-through, the domestic terms of consumption equals the terms of trade multiplied by the ratio of domestic to export markups.”

Another aspect that we examine is the effects of G shocks on labour and total factor productivities. Based on different VAR estimation approaches using US data, [Bachmann and Sims \(2012\)](#), [d’Alessandro, Fella, and Melosi \(2019\)](#), [Jørgensen and Ravn \(2022\)](#), and [Klein and Linnemann \(2022\)](#) all find that TFP increases significantly following positive G shocks. For instance, [Klein and Linnemann \(2022\)](#) show that the responses of labour productivity, TFP, and utilization-adjusted TFP are almost as large and as persistent as the response for output. To the best of our knowledge, we are the first ones to document VAR evidence on this dimension for Canada. Since Statistics Canada does not provide quarterly series of TFP, we use the estimates of [Cao \(2021\)](#) for the business sector which are available between 1976Q1 and 2018Q3 on his [website](#). Unfortunately, his series is not adjusted for factor utilization, as are the estimates of [Fernald \(2014\)](#) for example.¹⁷ As can be seen in [Figure 4](#), both the median responses of labour productivity and TFP are increasing following a positive G shock. On impact, both variables increase as much as real GDP; however, the effects on productivities are not as persistent. The main implication for theoretical models is that mechanisms that involve endogenous changes in productivity are worth investigating as they can explain partially the large G multipliers.¹⁸ However, there are some limitations to the analysis, since, based on our VAR evidence, it is not clear whether the rise in TFP reflects technology improvements or simply heightened utilization rates of capital and labour.

All the impulse responses to G shocks and G multipliers that we have presented so far are obtained under the assumption that G is unanticipated. However, as argued by [Ramey \(2011\)](#) and [Auerbach and Gorodnichenko \(2012\)](#), it is also important to consider agents’ anticipations of G . Hence, we follow one of [Auerbach and Gorodnichenko’s \(2012\)](#) specification which consists in augmenting the baseline model with $\Delta g_{t|t-1}^f$, *i.e.* the expected growth rate of G_t conditional on the information set at time $t - 1$. As a proxy to agents’ anticipations of G , we use the Bank of

¹⁷[Cao \(2021\)](#) does compare the time series of TFP with TFP adjusted for utilization in [Figure 3](#). His adjustment simply consists in removing capacity utilization defined as the ratio of actual output over potential output. However, since the two series display a strong negative correlation, we prefer not to use the adjusted series.

¹⁸[d’Alessandro, Fella, and Melosi \(2019\)](#) introduce skill accumulation and a learning-by-doing mechanism, while [Jørgensen and Ravn \(2022\)](#) and [Klein and Linnemann \(2022\)](#) focus on variable cyclical technology utilization.

Canada’s Staff Economic Projections and the real-time historical data contained therein—which are available on a quarterly frequency from 1986Q4 to 2015Q4.¹⁹ Adding this variable to the model ensures us that the disturbances in G_t that we identify are orthogonal to the anticipations. We augment the baseline model with this variable and we follow the literature in imposing zero contemporaneous restrictions on other shocks to explain its dynamics. We estimate this augmented model and the baseline model over the same time period. We do not find any significant differences in the G multipliers, and the median response of real GDP to an anticipated G shock is close to zero.²⁰ Therefore, our results are robust to the anticipations of G .

Prior to examining the potential transmission channels, we investigate the effects of G_C and G_I shocks separately as is typically done in the literature. One important characteristic of Canadian G_C is that the production of these public goods is on average more labour-intensive than the production of private goods. Therefore, this feature allows us to introduce additional sign restrictions on the response of the labour income share; specifically that, it needs to be positive (negative) on impact in response to a positive G_C (G_I) shock. The justification of the restriction on the G_I shock is simply that an increase in public capital increases the share of all capital in GDP which implies that the labour share falls.²¹ All the other restrictions are the same as the ones used to estimate the baseline model. Moreover, in order to consider the responses of G_I to a G_C shock, and vice-versa, we adapt the computation of the cumulative multiplier (equation (3)), such that:

$$CM_{G_C}(h) = \frac{\sum_{j=0}^h (1 + \bar{r})^{-j} Y_{G_Cj}}{\sum_{j=0}^h (1 + \bar{r})^{-j} \left(G_{CCj} + G_{ICj} \frac{\bar{G}_I}{\bar{G}_C} \right) \bar{G}_C} \bar{Y} \quad (4)$$

where Y_{G_Cj} corresponds to the median impulse response of real GDP to a positive G_C shock

¹⁹Typically, researchers use forecasts for G that are provided by the OECD; however, these forecasts are only available at a semiannual frequency.

²⁰These results are available upon request to the authors.

²¹The aggregate production function that we have in mind is not Cobb-Douglas, but one that sums sectoral productions which feature different labour income shares.

at horizon j . As for the responses of government spending, G_{CCj} and G_{ICj} , note that the first subscript position indicates the response of G_C or G_I , while the second subscript position indicates that the variable shocked is G_C . The terms with a bar above them are the average values of the variables over the sample period.²² This adjustment of the multipliers is needed to consider the effects of both categories of government spending when examining the effects of a shock specific to one of these categories. Since we consider total changes in G when computing the multipliers of a specific category of G , we need to sum the responses of both categories.²³

Figure 5 presents the cumulative multipliers for G_C and G_I . The shape of the G_C multipliers over time is similar to the ones obtained for G multipliers, and they are all above unity. Since G_C accounts for the majority of government expenses, this result is not surprising. The persistence of their effects can be linked to accrued spending in education which improves aggregate human capital, and thereby labour productivity at short and long horizons. As for the G_I multipliers, they also all are above unity; however, their shape differs markedly. In fact, the large effects that we find on impact dissipate over a longer horizon. On average, G_I multipliers are greater than G_C —which is consistent with the meta-analysis conducted by Gechert (2015) that reports an average gap of 0.5 unit between these two categories of G multipliers.²⁴

One factor that can explain why we find large G_I multipliers is that the level of Canadian public capital is low, and potentially suboptimal. As can be seen in Figure 6 in Appendix A, there is a significant downward trend of the G_I -to-GDP ratio between 1960 and 2000 roughly. Based on data from the IMF, the ratio of public capital over GDP also follows a similar trend. We argue

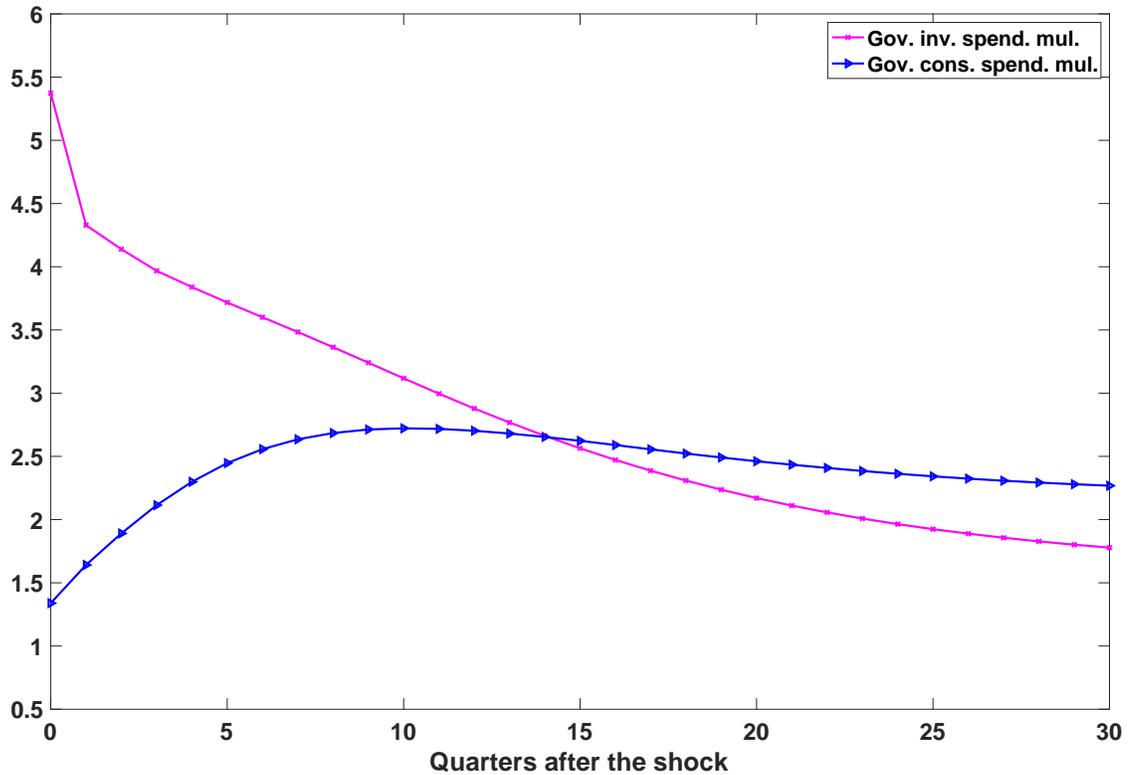
²²The cumulative multipliers for G_I are obtained symmetrically from the following equation:

$$CM_{G_I}(h) = \frac{\sum_{j=0}^h (1 + \bar{r})^{-j} Y_{G_Ij}}{\sum_{j=0}^h (1 + \bar{r})^{-j} \left(G_{IIj} + G_{CIj} \frac{\bar{G}_C}{\bar{G}_I} \right)} \frac{\bar{Y}}{\bar{G}_I}. \quad (5)$$

²³The adjustment term in the denominator is required because these responses are not expressed in the same units.

²⁴However, based on a panel of OECD countries, Boehm (2020) finds G_I multipliers that are not different from zero in the short-run.

Figure 5: The cumulative multipliers of government expenditures in consumption and in investment



Note: See equations (4-5) for the details on the construction of these multipliers.

that it has been too low in Canada, and that this sub-optimality leads to greater G_I multipliers. We do not provide a precise account of this sub-optimality; however, Table 3 shows that, on the public capital measure, Canada ranks 14th out of 19 advanced countries. Even though government total tax receipts in the US are lower per capita than in Canada, its average ratio of public capital over GDP is over 20 percentage points than Canada's.

There is a vast literature on the positive externalities that public capital creates on the private production of goods and its effects on long-run economic growth. When the elasticity of output with respect to public capital is assumed to be constant, one can derive its socially optimal level—

Table 3: Average public capital stock to GDP ratios for OECD countries (1961-2017)

Japan	115%	Portugal	65%
New Zealand	113%	Finland	63%
Sweden	99%	Norway	61%
Denmark	93%	Canada	61%
United States	83%	Switzerland	55%
Netherlands	82%	Korea	54%
Austria	79%	Italy	52%
United Kingdom	74%	Belgium	51%
Germany	71%	Ireland	42%
France	70%		
Mean	73%		
Median	70%		

Source: The IMF Investment and Capital Stock Dataset (IMF 2017).

Notes: The ratio of general government capital stock over GDP is in national currency (current costs and prices). We selected OECD countries for which a long span of data is available. All the national series end in 2017, and most of them start in 1960, except for Austria (1970), Canada (1961), Denmark (1971), Italy (1970), Korea (1970), New Zealand (1962), and Portugal (1977).

as shown by Ramey (2020) for example. She also finds that a public capital-to-GDP ratio which would be lower in the steady state than the optimal ratio contributes in elevating the G_I multipliers. The effects are quantitatively important and are at force for the neoclassical and New Keynesian models that she puts forward. In fact, for a given optimal public capital-to-GDP ratio, the lower its steady state value is the greater the multiplier is.²⁵ This inverse relationship is analogous to the one between the marginal product of capital and its level. As simulations of theoretical models show that the average level of public capital significantly affect the size of the G_I multiplier, we conjecture that the low level of public capital in Canada also matters for the multiplier that we estimate.

²⁵Specifically, for an aggregate production function that features public capital, she shows that the optimal ratio of public capital to GDP is given by $\theta_G / (\beta^{-1} - 1 + \delta_G)$ where θ_G corresponds to the elasticity of output with respect to public capital, β to the discount factor, and δ_G to the depreciation rate of public capital. For the following parameterization: $\theta_G=0.1$, $\beta=0.99$, and $\delta_G=0.01$, this implies an optimal ratio of 124% (annualized). With an initial steady state ratio of public capital to GDP of 87.5%, she finds long-run multipliers of 2.2 and 2.8 for the baseline neoclassical and New Keynesian models, respectively. With a lower initial steady state ratio of 37.5%, these multipliers jump up to 4.4 and 5.4.

5 Conclusion

We find high and persistent G multipliers for Canada, which are above 2 on impact and for all horizons up to 8 years after the shock. These results ensue from the estimation of a vector autoregressive model where G shocks are identified using the sign restrictions approach. They also challenge the received idea about fiscal policy in the context of small open economies which calls for smaller G multipliers when trade integration is large. We find that imports increase following positive G shocks; however, exports also increase by the same margins which offsets the role of net exports in explaining G multipliers. This finding, coupled with responses of international price variables that are not significantly different from zero, suggests that policy-makers should focus on national factors when evaluating the effects of spending hikes and cuts. Moreover, the multipliers that we find are not conditional on the state of the Canadian economy, *i.e.* whether it is in recession or in expansion. Given the implementation lags of government spending, this result is good news for policy-makers as they do not need to worry about the state of the business cycles to give the go-ahead for publicly-funded projects. Another interesting result that we find is that TFP rises almost one-for-one with the increase in output following positive G shocks.

Finally, as it is typically done in the literature, we decompose government spending into expenses in consumption (G_C) and in investment (G_I). The multipliers for both of these categories are consistently above one, for horizons that range from 0 to 8 years after the shock. The peak of these multipliers are large: above 2.5 and 5 for G_C and G_I , respectively. One explanation for such high multiplier for G_I is that Canada suffers from low levels of public capital relative to its GDP which signifies high marginal product of this type of capital, and therefore, greater sensitivity of output to changes in public investment.

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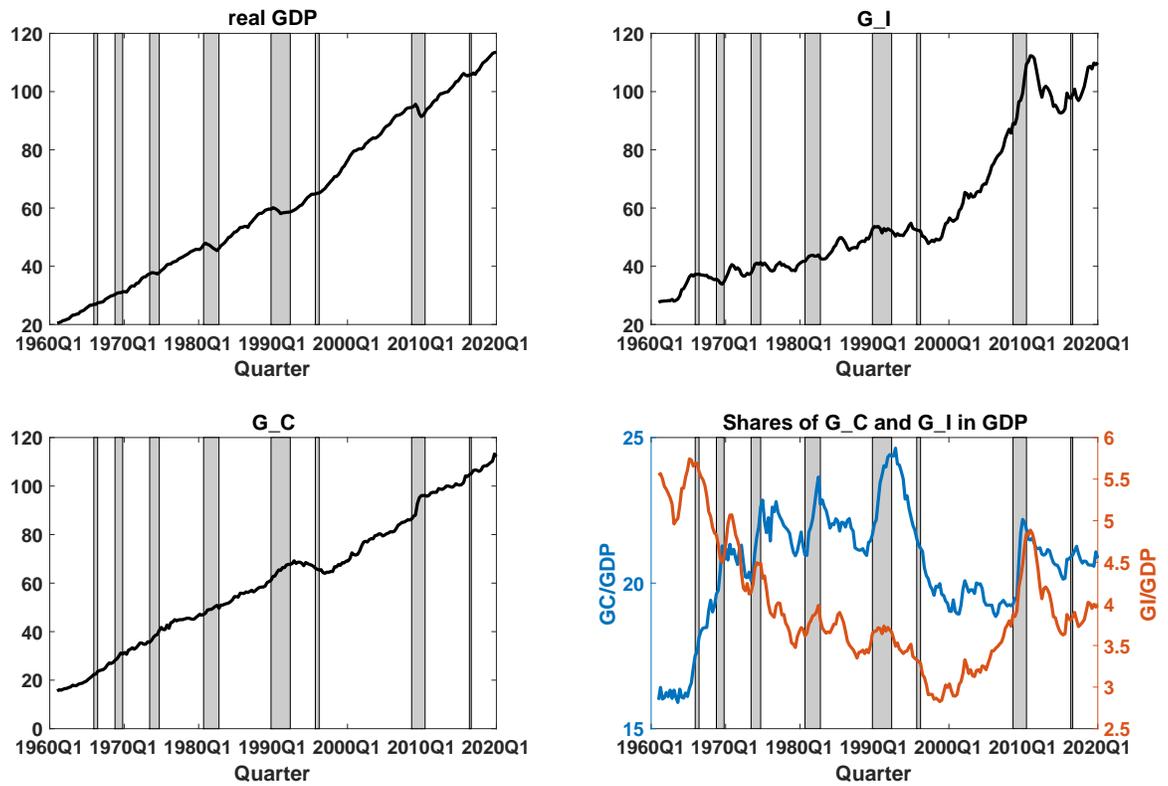
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Appendices

A Data

Figure 6: Main Canadian time series that we use for the estimations



Notes: The index of the real GDP, G_I , and G_C time series is 2012Q1=100, while the shares of G_C and G_I in GDP are expressed in percentages. The shaded areas correspond to recessions which are identified such that 20% of periods are recessionary. See Appendix C for details.

B Technical details on the methodology

This appendix contains technical details on the methods used to construct the set of admissible structural models and Bayesian credible sets for the impulse responses. The objective is to compute response functions to impulses in the structural shocks ε_t . From (1) and (2), we have $u_t = B_0^{-1}\varepsilon_t$, and it can be seen that structural impulse responses could be obtained from the reduced-form impulse responses if B_0^{-1} was known. Let P be the lower-triangular Cholesky decomposition of Σ_u . Then, by definition, $u_t = Pe_t$, where e_t is a k -vector of uncorrelated random variables. Let Q be a $k \times k$ matrix such that $QQ^\top = I_k$. Then, $u_t = PQQ^\top e_t = B_0^{*-1}\varepsilon_t^*$, where $B_0^{*-1} = PQ$ is a candidate impact matrix and ε_t^* is a candidate vector of uncorrelated structural shocks.

The set of admissible structural models consists of all candidate matrices B_0^{*-1} that satisfy the sign restrictions. This set is constructed using the following algorithm.

Step 1. Estimate the reduced form VARX model (1) by OLS to obtain estimates \hat{A}_1 , \hat{A}_2 , \hat{C}_1 and $\hat{\Sigma}_u$ of the coefficient matrices. Let \hat{P} be the lower-triangular Cholesky decomposition of $\hat{\Sigma}_u$.

Step 2. Draw a $k \times k$ matrix H of independent $N(0,1)$ random variables. Derive the QR decomposition of H such that $H = QR$ where $QQ^\top = I_k$.

Step 3. Construct the matrix $\hat{B}_0^{*-1} = \hat{P}Q$ and the associated impulse responses. If \hat{B}_0^{*-1} satisfies the sign restrictions, retain the impulse responses. If not, discard the impulse responses.

Step 4. Repeat steps 2 and 3 M times. For large enough M , the set of retained models should be a good approximation to the admissible set.

The result of this algorithm is not a point estimate of the impulse responses (or the multiplier) but a set of admissible responses and multipliers. This poses the question of what quantity should be reported to convey the most meaningful information about the findings of the model and how

inference should be conducted. Bayesian methods are typically used with sign-identified VAR models. We follow this approach and report pointwise posterior median responses and credible sets.

To do this, draws are taken from the posterior distribution of the coefficients matrices of the reduced-form VARX model (1) and of Σ_u . Then these simulated coefficients are substituted in step 1 of the algorithm instead of the OLS estimates and the algorithm is run. Repeating the algorithm N times yields a set of impulse responses and multipliers drawn from the posterior of the structural model. If N is sufficiently large, this can be used to conduct inference, see section 13.6.2 of [Kilian and Lütkepohl \(2017\)](#) for details.

In the present paper, we use the common Gaussian-inverse Wishart prior for the coefficients of the reduced form VARX model. Drawing the rotation matrix Q in the way described above is equivalent to imposing a Haar prior on it. It is known that the choice of prior for the rotation matrix may be informative for the coefficients of the structural model and consequently for the structural responses ([Baumeister and Hamilton 2015](#)). The only satisfying solution to this problem would be to impose a prior for the elements of the matrix B_0^{-1} or on the structural responses themselves. Because we have no convincing theoretical basis on which this could be done, we use the standard approach and impose the Haar prior on the rotation matrix. The reader may consult section 13.7 of [Kilian and Lütkepohl \(2017\)](#) for a discussion of this issue.

C Details on the 2-regime model

Some of the results reported in the paper explore the possibility that the government expenditure multiplier may be different in recessions and in expansions. This analysis is carried-out using a two-regime threshold version of the VARX model (1). This two-regime specification is

$$y_t = I(z_{t-1} < \bar{z}) [A_{R,1}y_{t-1} + A_{R,2}y_{t-2} + C_{R,1}X_t] + (1 - I(z_{t-1} < \bar{z})) [A_{E,1}y_{t-1} + A_{E,2}y_{t-2} + C_{E,1}X_t] + u_t, \quad (6)$$

with

$$E(u_t u_t^\top) = \Sigma_u = I(z_{t-1} < \bar{z}) \Sigma_{R,u} + (1 - I(z_{t-1} < \bar{z})) \Sigma_{E,u}, \quad (7)$$

where the subscripts R and E denote matrices and vectors of parameters in recession and expansion respectively and z_t is an observed threshold variable. Model (6) is a special case of [Auerbach and Gorodnichenko's \(2012\)](#) smooth transition VAR model with the smoothness parameter set to 0. This value is imposed to simplify the estimation of the model, but our results do not appear to be affected by this choice.

We follow [Auerbach and Gorodnichenko \(2013\)](#) in defining z_t to be the deviation of a seven-quarter moving average of real GDP growth centered around period t and its trend counterpart as extracted with the Hodrick-Prescott filter with a smoothing parameter $\lambda = 40,000$. The value of the threshold \bar{z} is chosen so that the economy spends 20% of the time in recession. The [C.D. Howe Institute](#) identifies less recessions for Canada than we do; however, the quarters that are labeled as recessions are a subset of the ones that we identify. Moreover, our results are not affected when we use a recession dating provided by the [OECD](#).

The fact that the coefficient matrices and vector in (6) and the covariance matrix (7) are regime-dependent means that a regime-dependent version of the structural model (2) corresponds to (6). We consequently use the sign-identification strategy in Section 3.

Table 4: Sources and definitions of variables

Variable	Source and definition
GDP deflator [P]	SC Table: 36-10-0106-01, line 36
US GDP deflator [P_{US}]	U.S. Bureau of Economic Analysis, Table 1.1.4
Real gross domestic product [GDP]	$GDP = \text{nominal GDP} / P$, source of nominal GDP: SC Table: 36-10-0104-01, line 40
Government expenditures in consumption [G_C]	SC Table: 36-10-0104-01, line 19
Government expenditures in investment [G_I]	SC Table: 36-10-0104-01, line 28
Total government expenditures [G]	$G = G_C + G_I$
Government revenues [T]	SC Table: 36-10-0477-01, we use Blanchard and Perotti's (2002) definition, <i>i.e.</i> $T = \text{General government revenues} - \text{Current transfers to households} - \text{Current transfers to non profit institutions serving households} - \text{Subsidies} - \text{Current transfers to non residents} - \text{Capital transfers}$
Real interest rate [r]	$r = \text{nominal interest rate} - \text{expected inflation rate}$, nominal interest rate corresponds to the Treasury bill auction - average yields: 3 month, source: SC Table: 10-10-0122-01, line 43, and the expected inflation rate to the one-quarter inflation rate (growth rate of the GDP deflator) that is observed ex-post.
Net exports to GDP ratio [NX/GDP]	Source of net exports: SC Table: 36-10-0121-01, line 10
Nominal exchange rate between the Canadian and U.S. dollars [E]	International Financial Statistics (IMF)
Real exchange rate RER	$RER = E \cdot P_{US} / P$
Terms of trade	They correspond to the price ratio of imports over exports from SC Table: 14-10-0289-01
U.S. real GDP [GDP_{US}]	U.S. Bureau of Economic Analysis, Table 1.1.3
Labour productivity	Ratio of real GDP to total hours worked in the business sector taken from Shutao Cao's website (1976Q1-2018Q3)
Total factor productivity	Business sector estimates of Shutao Cao and available on his website (1976Q1-2018Q3)
Expected growth in G [$\Delta g_{t t-1}^f$]	Staff Economic Projections of the Bank of Canada (1986Q4-2015Q4). Since the forecasts of G_t are in nominal terms, we deflate them using the forecasts of the implicit price deflator for GDP also available in the Staff Economic Projections.
Labour share	Total compensation/GDP, source of compensation of employees: SC Table: 36-10-0114-01, line 4

Notes: SC stands for Statistics Canada. Unless it is specified, all the variables that we use are Canadian, and all of them span from 1961Q1 to 2019Q4.