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# The Impact of Fiscal Policy on Aggregate Economic Activity: A Regime Dependent Impulse Response Analysis

**Wajid Ali[1], Iftikhar Ahmad[2]**
[1]Eastern Mediterranean University, Turkish Republic of North Cyprus.
Email: wajidkhan2272@gmail.com
[2]Pakistan Institute of Development Economics, Islamabad Pakistan.

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## Abstract

*Asymmetries in fiscal policies cannot be captured by linear time series models. In order to examine the asymmetry responses of output in different phases of the business cycle, Markov Regime Switching (MRS) model is an alternative technique that is used to achieve the objective. The main objective of this study is to empirically explore the effects of fiscal shocks (spending and taxes) on Pakistan's overall economic activity GDP while utilizing the Markov Switching MS-VAR model. The model is characterized to allow for the variation in mean, coefficients and in error variances. The study results show that the effect of shocks and the size of multipliers vary across regimes confirming the asymmetric behavior of fiscal policy transmission mechanism. Moreover, the impact of positive spending shock has a stronger effect on output in the recession as compared to boom. One surprising result of the study is that the tax shock increases the output both in recession and boom. Lastly, spending and revenue behave a-cyclically.*

***Keywords:*** MSVAR model, fiscal policy, nonlinear effect, economic activity

***JEL Classification Codes:*** C11; C32; E62