Progressive Taxation and Macroeconomic (In)stability

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Abstract

It has been shown that in an otherwise standard one-sector real business cycle model with an indeterminate steady state under laissez faire, sufficiently progressive income taxation may stabilize the economy against aggregate fluctuations caused by agents' animal spirits. We show that this previous finding can be overturned within an identical model which allows for sustained endogenous growth. Specifically, progressive taxation may operate like an automatic destabilizer that leads to equilibrium indeterminacy and sunspot-driven cyclical fluctuations in an endogenously growing macroeconomy. This instability result is obtained under two tractable progressive tax policy formulations that have been considered in the existing literature.