Accepted Manuscript

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Brendan Epstein, Rahul Mukherjee, Shanthi Ramnath

PII: S0022-1996(16)30089-7
DOI: doi: 10.1016/j.jinteco.2016.08.002
Reference: INEC 2973

To appear in: *Journal of International Economics*

Received date: 10 September 2014
Revised date: 31 July 2016
Accepted date: 8 August 2016

Please cite this article as: Epstein, Brendan, Mukherjee, Rahul, Ramnath, Shanthi, Taxes and International Risk Sharing, *Journal of International Economics* (2016), doi: 10.1016/j.jinteco.2016.08.002

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Taxes and International Risk Sharing

Brendan Epstein * Rahul Mukherjee† Shanthi Ramnath‡

August 11, 2016

Abstract

We extend a standard model of international risk sharing to include an empirically plausible distortion: Taxes. The tax-inclusive theory implies, even under full risk sharing, a predictable relationship between consumption growth and the consumption and capital income tax rates, both within and across countries. We find strong empirical evidence in favor of this relationship. While idiosyncratic output fluctuations account for substantially more of cross-country consumption growth variability than do taxes, trends in tax differentials are found to be informative about the dynamic evolution of international risk sharing. In particular, adjusting for capital taxes reveals a marked improvement in risk sharing over the last three decades that is absent in baseline measures. This improvement has been driven by the convergence of average tax rates on capital income across OECD countries towards the United States average capital tax rate.

Keywords: International risk sharing; business cycle accounting; risk-sharing wedges; tax convergence; capital taxes.

JEL Codes: F41, F44, H29.

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*Board of Governors of the Federal Reserve System. E-mail: brendan.epstein@frb.gov.

†**Corresponding author:** IHEID, Geneva. E-mail: rahul.mukherjee@graduateinstitute.ch.

‡U.S. Treasury Department, Office of Tax Analysis. E-mail: Shanthi.Ramnath@Treasury.gov.

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