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Home Production, Balanced-Budget Taxation and Economic (In)Stability

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Abstract

This paper examines the instability property of balanced-budget taxation on factor income and consumption in a two-sector real business cycle model with home production. We show that the presence of home production, which is a nontaxed sector, reinforces the intratemporal and intertemporal substitution effects of balanced-budget rules. As a result, it strengthens the destabilization effect of factor income taxes and weakens the stabilization effect of consumption taxes. Moreover, our calibration shows that the number of OECD countries' tax-rate combinations that fall into the instability region rises when home goods account for a larger share of aggregate consumption, and hence persistent cycles can easily occur following a fundamental shock or a sunspot shock.

JEL classification: E32; E63

Keywords: Balanced-budget rules; Home production; Elasticity of substitution; Factor shares; Indeterminacy

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