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# Balanced-budget income taxes and aggregate stability in a small open economy

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## Abstract

In a closed economy, a balanced-budget fiscal policy rule with endogenous income tax rates can generate aggregate instability due to self-fulfilling expectations (e.g., Schmitt-Grohé and Uribe 1997). This paper shows, both analytically and numerically, that beliefs-driven aggregate instability associated with such a balanced-budget rule is less of a problem in a small open economy integrated in the world asset and goods markets. This is because cross-border capital flows and endogenous international price adjustments produce income effects that reduce the likelihood of sunspot equilibria. From a policy perspective, our results relieve possible concerns that balanced-budget rules and reliance on income taxes to achieve budget objective could have destabilizing effects on the economy.

*JEL classification:* E32; E62; F11; F4

*Keywords:* Small open economy; Balanced-budget rules; Income taxes; Saddle-path stability; Sunspots; Self-fulfilling expectations; Indeterminacy

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