OPTIMAL TAX RATES ON GROSS CAPITAL FLOWS

Kyongjun Kwak*

[Click HERE for the full paper]

Oct 21, 2021

Abstract: This study seeks to find optimal tax rates on gross capital flows. I construct a simple three-period model of pecuniary externalities where private domestic agents do not consider the effect of borrowing or overseas investment decision on their own financial constraint. The model differs from previous efforts in that it explicitly differentiates gross inflows (i.e., borrowing from foreign investors) from gross outflows (i.e., overseas investment in foreign assets) to reflect the significant increase of gross outflows in emerging economies. I show that the optimal tax rate on gross inflows is 0.8%p higher when foreign assets are included in the model, which is due to greater unintended side effects of borrowing through the channel of foreign asset prices. The findings generalize previous models that only use net flows by illustrating how externalities can be corrected with Pigouvian tax on borrowing as well as subsidy on overseas investment. This study also provides new policy insights into capital flow management by suggesting separate management of gross inflows and outflows.

Keywords: Capital Flow Management, Gross International Capital Flows, Pecuniary Externalities, Pigouvian Taxation

JEL Codes: F32, F38, G18, H23

---

* Ph.D. Candidate, Department of Economics, University of Washington. E-mail: kk83@uw.edu