

Unconventional prudential policy: when are capital controls optimal?^{*}

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February 14, 2026

Abstract

In an open economy with downward real wage rigidity, the effects of economic fluctuations may be amplified. Furthermore, the wage rigidity creates a negative externality since the current wage floor is a function of the past wage. If it is impossible to implement a fiscal devaluation, the optimal fiscal policy response to downward wage rigidity is characterized by time-varying labor and capital income taxes and zero capital control taxes. Prudential labor income taxes decrease when the wage floor is expected to bind in the future to reduce the current wage and the future wage floor. However, if labor income taxes are unavailable, it becomes optimal to use capital controls prudentially. In this case, a higher capital control tax implements a lower equilibrium wage through its effect on labor supply. We, thus, identify a novel mechanism for the optimality of capital controls in the context of downward wage rigidity.

Keywords: Fiscal policy, optimal taxation, downward wage rigidity, externalities, macroprudential policy, capital controls

JEL Classification: E24, E32, E62, F38, H21

^{*}A previous version of this paper circulated with the name "Optimal Prudential Taxation". We are grateful to V.V. Chari, Larry Jones, Christopher Phelan, Anmol Bhandari, Marco Bassetto, Pedro Teles, Isabel Correia, Carlos E. da Costa, Sebastian Dyrda, Leonor Modesto, Teresa Lloyd Braga, and Mateus Santos for helpful comments and suggestions. We are also thankful to the seminar participants of the University of Minnesota Workshops, University of Surrey, Cologne University and Lisbon Macro Workshop, as well as the conference participants of the Portuguese Economic Journal Meetings, the Society for the Advancement of Economic Theory Meetings, the LuBraMacro Meetings, the Taxation Theory Conference, and the Asian Meeting of the Econometric Society. Reis is grateful for the financial support from Fundação para a Ciência and Tecnologia (FCT). All errors that remain are our own.

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