

Box 12

FISCAL DEVALUATION – A TOOL FOR ECONOMIC ADJUSTMENT

In addition to fiscal difficulties, some euro area countries are also faced with competitiveness problems, leading to persistent current account deficits. As nominal devaluation is not possible for countries participating in a currency area, competitiveness has to be regained domestically. This requires productivity-enhancing structural reforms and adjustment of relative prices, in particular real wage moderation. This box looks, from an analytical perspective, at the policy option of a “fiscal devaluation”, which has been proposed in the literature as another tool that could contribute to the economic adjustment process.

Fiscal devaluation is the use of the tax system to mimic a nominal devaluation of the exchange rate, in particular by increasing taxes on imports and reducing them on exports, thereby changing the relative price of domestic and foreign goods. In practice, this can be achieved indirectly by cutting taxes that increase the cost of production, such as payroll or corporate income taxes, and therefore also affect the cost of exports, financed by an increase in VAT (remembering that exports are zero-rated) or property taxes. However, owing to differences in timing of receipts and the speed of behavioural responses, short-term revenue losses could occur even for a budget-neutral tax reform and could pose an obstacle to countries with short-term fiscal constraints. Moreover, the analogy with a change in the nominal exchange rate is not perfect, as a fiscal devaluation is not accompanied by an increase in the domestic money supply.

Theoretical analysis supports the idea that a fiscal devaluation can help in regaining competitiveness. The move from an origin to a destination-based tax, such as from a labour or corporate income tax to a VAT or sales tax, leads to an immediate fiscal depreciation. Typically this would have no long-term impact,¹ because the real effective exchange rate will ultimately adjust, either through appreciation (for countries subject to a flexible exchange rate) or inflation (for countries in a fixed exchange rate, including those in a currency area). For certain euro area countries, however, the starting point is that of a disequilibrium characterised by an overvalued real effective exchange rate. Here, a fiscal devaluation would merely speed up a necessary adjustment process and it could not be expected to replace necessary structural reforms.

Furthermore, simulations using dynamic equilibrium models suggest that a fiscal devaluation would have to be large in order to generate a significant impact on competitiveness and trade. This is borne out by ECB staff simulations using the Euro Area and Global Economy (EAGLE) model, as well as other recent research.² Empirical evidence also tends to find that moderate shifts in domestic taxes have hardly any impact on trade.³ At the same time, no study has yet been undertaken that considers the particular case of countries in a currency area that start from an uncompetitive position.

1 See Grossman, G., “Border Tax Adjustments: Do They Distort Trade?”, *Journal of International Economics*, Vol. 10(1), pp. 117-128, 1980. See also Feldstein, M. and Krugman, P., “International Trade Effects of Value-Added Taxation” in Razin, A. and Slemrod, J. (eds.), *Taxation in the Global Economy*, University of Chicago Press, 1990, who argue among other things that VAT can affect trade if it replaces a distortionary tax or if tax rates applied to the tradable sector differ in practice from those in the rest of the economy.

2 See Franco, F., “Improving competitiveness through devaluation, the case of Portugal”, mimeo, New University of Lisbon, 2010; Lipińska, A. and von Thadden, L., “Monetary and fiscal policy aspects of indirect tax changes in a monetary union”, *Working Paper Series*, No 1097, ECB, Frankfurt am Main, October 2009.

3 See Desai, M.A. and Hines, J.R., “Value-Added Taxes and International Trade: The Evidence”, mimeo, University of Michigan, 2002; and Keen, M. and Syed, M., “Domestic Taxes and International Trade: Some Evidence”, *Working Paper Series*, IMF, WP/06/47, 2006.

Nevertheless, reforms that shift taxation from inputs to consumption are likely to be beneficial from a broader economic perspective. Moving away from taxes on labour income or profits and towards consumption or property taxes could boost growth structurally in addition to the (possibly small) effect from higher net exports. Such a reform would reduce the tax bias against saving and promote labour supply. Moreover, the more attractive tax structure might encourage investment, including by fostering foreign direct investment. There is strong empirical evidence that moving towards taxing consumption or property has a positive impact on growth.⁴

To safeguard any improvement in competitiveness achieved as a result of fiscal devaluation, it is important to prevent an increase in inflationary expectations. On the one hand, if corporate income taxes or employer-paid payroll taxes are cut, then production costs are immediately reduced, which will also allow a reduction in prices net of VAT, so that inflation net of the VAT effect is likely to be lower, although the impact is uncertain and profit margins could also increase. On the other hand, the accompanying increase in VAT will have an immediate one-off impact on inflation, with the risk that possible second-round effects on wages and prices counter any beneficial impact on competitiveness. In countries with automatic rules linking wage adjustments to inflation, the competitiveness gain would necessarily be short-lived.

Overall, a fiscal devaluation whereby labour or corporate income taxes are replaced to some extent by VAT or property taxes can make a positive – if small – contribution to the required economic adjustment in euro area countries with competitiveness problems. At the same time, a fiscal devaluation cannot be a substitute for, but only a complement to, necessary structural reforms. Beyond these considerations, a more efficient tax structure which favours saving and investment can be conducive to higher real growth more generally.

4 See, for example, Johansson, Å. et al., “Taxation and Economic Growth”, *Economics Department Working Papers*, OECD, No 620, 2008, who find that VAT and property taxes are the least harmful taxes for growth, while labour and corporate income taxes are the most damaging. For the specific case of a small euro area country, Alemeida, V. et al., “Fiscal consolidation in a small euro area economy”, *Working Paper Series*, Banco de Portugal, May 2011, use a New-Keynesian general equilibrium model to look at different options for fiscal consolidation. They find that an increase in VAT is better for growth and employment than an increase in the labour tax, although expenditure cuts are better than either option.