

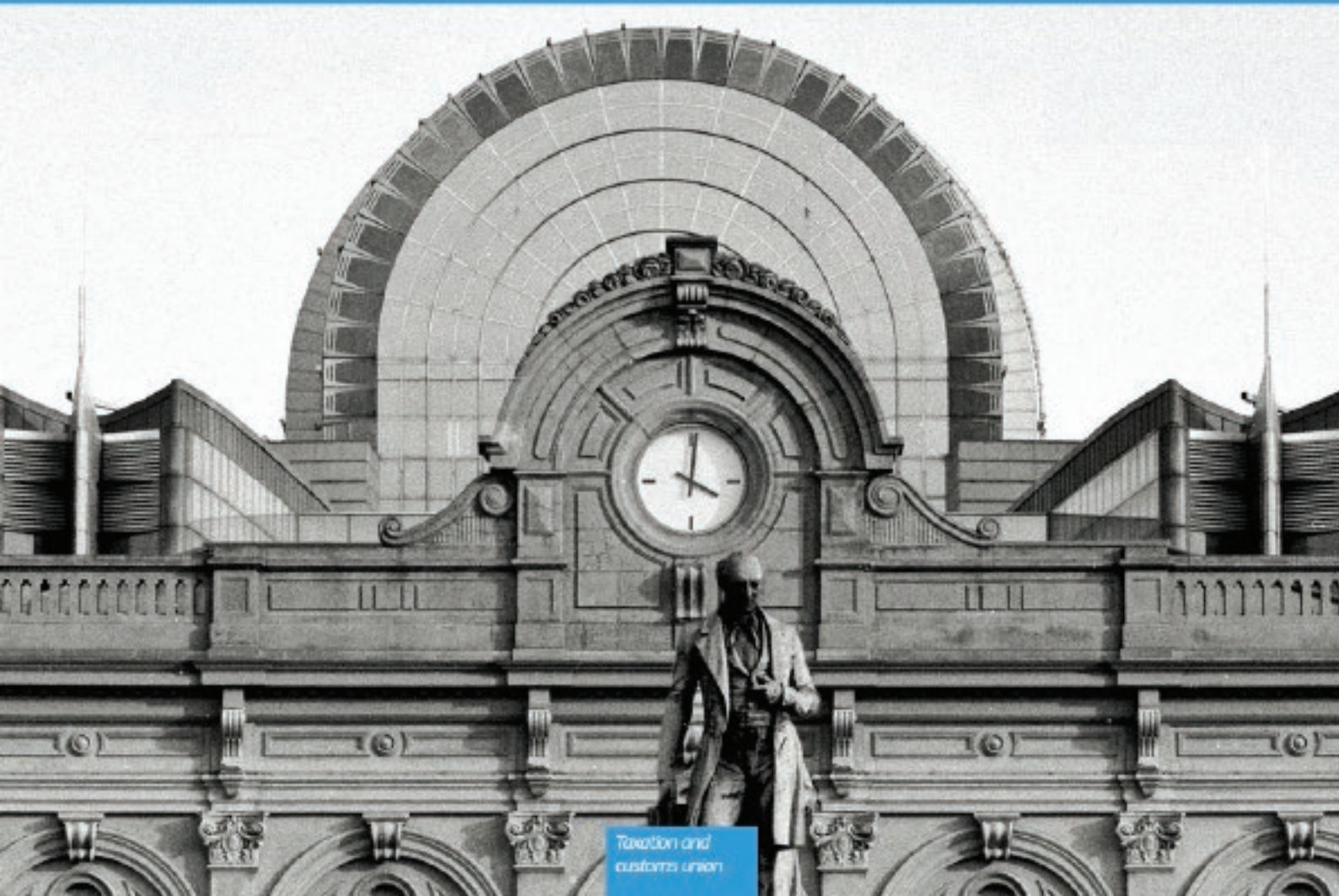


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Laura Puglisi

Fiscal Devaluations in the Euro Area: What has been done since the crisis?



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FISCAL DEVALUATIONS IN THE EURO AREA: WHAT HAS BEEN DONE SINCE THE CRISIS?

Laura Puglisi¹

September, 2014

Abstract: In recent years, the concept of a fiscal devaluation has been advocated as fiscal policy alternative to nominal exchange rate devaluations for peripheral deficit countries in the euro area to regain competitiveness. This paper investigates if countries in the euro area implemented fiscal devaluations in the aftermath of the economic and financial crisis and if so, how these reforms are expected to affect their competitiveness positions. Despite much discussion, no country has yet undertaken a substantial fiscal devaluation. Some (targeted) reductions in social security contributions were introduced, mainly to create job incentives, while consumption taxes (VAT) were increased – in some cases substantially – mainly for consolidation purposes. Although countries could benefit from a fiscal devaluation, their feasibility is politically constraint and effects are likely to be small in magnitude relative to the size of economic problems. Overall, fiscal devaluations cannot be a substitute for deep structural reforms that are urgently needed to address the underlying weaknesses of European economies.

JEL classifications: F10, H24, H87

Keywords: European Union; Euro Area; taxation; tax policy; fiscal devaluation; VAT; social security contributions; political economy; cost competitiveness

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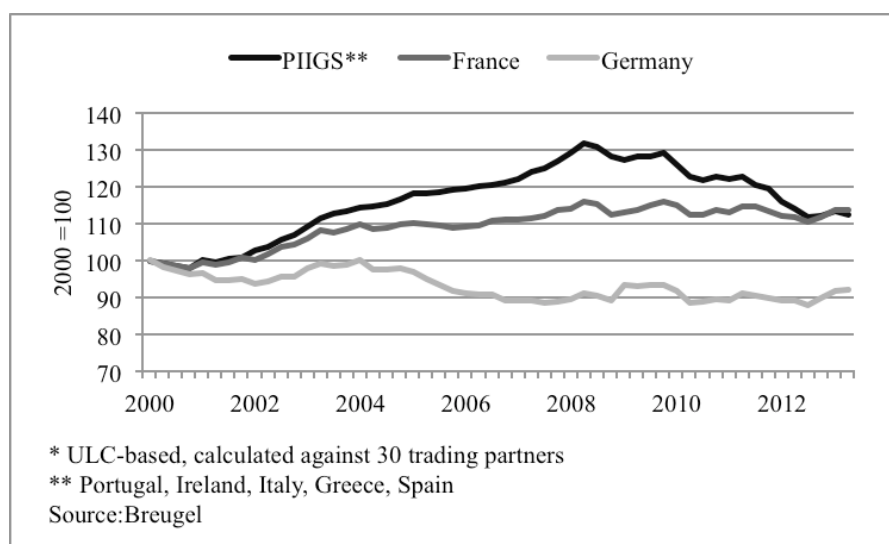
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I. Introduction

Since the launch of the euro, nominal exchange rates have been fixed between members of the euro area, but their real exchange rates diverged considerably (Figure 1) contributing to the build-up of large current account deficits in the run up to the crisis (Coudert et al., 2012). Regardless of the various underlying causes of external imbalances, as the crisis hit, governments had to put credible reform strategies within a short space of time. At that time, fiscal devaluations have been advocated as an alternative policy option to boost competitiveness² in the short-run. By a shift from labour to consumption taxation, a fiscal devaluation can replicate the effects of a nominal exchange rate depreciation in a system of fixed exchange rates (Fahri et al. 2012) and thus supports the rebalancing of external accounts.

Figure 1: Real Effective Exchange Rates* in Euro Area Economies



This paper assesses if countries in the euro zone implemented fiscal devaluations in the aftermath of the economic crisis and if so, how these reforms are expected to affect their competitiveness positions. The structure of the paper is organised as follows: Section II. lays

² In this analysis, competitiveness always refers to cost (price) competitiveness, which is associated with improved efficiency and lower labour costs. This stands in contrast to technological competitiveness, which is associated instead with the development of new products and requires substantial internal innovation (R&D and design) (IMF 2013a).

out the basic mechanism of a fiscal devaluation and links it to the concept of a tax shift, which plays an important role in the European Commission's reform recommendations to member states in context of the European Semester. Section III. reviews the existing evidence from quantitative analyses on the effects of a fiscal devaluation on GDP, employment and export performance. Section IV. presents recent tax reforms in form of a fiscal devaluation in euro zone countries, followed by a preliminary assessment of the effects on macroeconomic variables in section V. The analysis will focus on countries that have implemented or announced a fiscal devaluation. Section VI. elaborates on the political economy forces of fiscal devaluations and key practical implementation issues. Section VII. concludes.

II. The Theoretical Workings of Fiscal Devaluations and the Link to Tax Shifts

The idea behind a fiscal devaluation is to improve external competitiveness by lowering the relative price of exports and by raising the relative consumer price of imports. In the context of tax policy, generally a fiscal devaluation takes the form of a (budget-neutral) reduction in employers' social security contributions (ESSCs) matched by an increase in the value added tax (VAT) rate. Theoretically, a fiscal devaluation works as follows: The cut in ESSCs directly reduces firms' labour cost. If the cost reduction is passed onto producer prices and if wages do not adjust downwards³, domestically produced goods become less expensive thereby reducing relative export prices and depreciating the real effective exchange rate. At the same time, the VAT hike does not offset the labour cost reduction, as only final consumption is taxed. While relative export prices decrease, relative import prices increase pushing down domestic import demand. On the one hand, consumer prices for domestically produced goods remain more or less unchanged, as the increase the VAT hike and the ESSC cut work in the opposite direction. On the other hand, the VAT hike is beard on imports – but not on exports – such that consumption is shifted towards domestic production. In sum, a fiscal devaluation stimulates exports and creates incentives to lower domestic import demand, such that the trade balance improves.

³ Downward (real and nominal) wage rigidity is defined as the extent to which workers are able to resist wage cuts. For empirical evidence on downward wage rigidity in a sample of European countries and the United States see Dickens et al. (2006).

Fiscal devaluations effect employment and output as well. The labour cost reduction triggers a rise in labour demand⁴ and output, as foreign import demand increases and as domestic consumers shift their consumption towards domestically produced goods. Over time, the increase in employment and the VAT-induced loss in the purchasing power of workers for imports put upward pressure on wages, which will offset the initial impact of the ESSC cut on production cost and stem the rise in employment. Due to adjusting real wages, domestic consumption gradually picks up and as parts of the additional consumption are spent on foreign goods, the initial improvement in the trade balance is gradually reversed. Overall, theory predicts that a fiscal devaluation leads to temporary improvement in the trade balance and to permanent increases in output and employment.

The concept of a fiscal devaluation is closely related to the one of a tax shift, which plays an important role in the Commission's reform recommendations to member states in context of the European Semester. Although both concepts involve the same type of policy measures, they differ in their policy objectives. While the aim of a tax shift is to make the tax system less distortionary and to promote employment and economic growth in the long-run (EC 2013), fiscal devaluations are a policy instrument to improve competitiveness in the short-term. A tax shift refers to a change in the structure of the tax system away from labour towards more growth-friendly taxes, such as consumption and environmental taxation as well as recurrent taxes on immovable property. A fiscal devaluation is a particular form of a tax shift as it is – in the standard case – specifically targeted to a reduction in ESSCs matched by an increase in the VAT rate.

In principle, governments could consider tapping growth-friendly tax revenue sources to refinance ESSC cuts, as it is reflected in the concept of a tax shift. Besides increasing consumption taxes – including not only the regular VAT rate but also reduced VAT rates and excise duties⁵ – governments could either increase environmental or recurrent property taxes. However, using environmental or recurrent property taxes as an alternative financing source does not necessarily lead to the same effects on the trade balance as a classical fiscal devaluation. The convenient feature of the VAT is that it does not offset the decrease in production costs. While VAT is charged on imported goods, it is not charged on exports

⁴ In a simple labour market model, lower real wages reduce labour supply while lower production costs increase labour demand. It is assumed that the latter effect dominates resulting in higher employment in equilibrium.

⁵ Excise duties are actually levied from the producer but typically they are passed on to producer prices.

between EU and non-member countries under the European VAT system. In addition, the VAT already paid by producers on the inputs of the export goods can be deducted, such that there is no residual VAT contained in the export price. This exemption with the right to deduct the input VAT is called “zero-rating”. In contrast, increasing property and environmental taxes could hamper the improvement in relative export prices by increasing production costs and offsetting the effect of an ESSC cut. To maintain the positive effect on relative export prices, it could be considered to exempt businesses from tax increases, but this in turn could lead to production inefficiencies and to distortions of the tax system. Alternatively, governments could curb governments spending to refinance ESSC cuts. The trade balance will likely improve, as relative export prices decrease and as consumers shift their consumption towards relatively less expensive domestic goods.

Table 1: Standard and alternative forms of fiscal devaluation in the area of tax policy

Standard Fiscal Devaluation	
Reduction in ESSC	Increase in VAT
Growth-friendly taxes as alternative financing sources for ESSC cuts?	
Reduction in ESSC	Increase in: <ul style="list-style-type: none"> • Reduced VAT rate⁶ • Excise duties • Property taxes • Environmental taxes Cuts in public expenditure

⁶ Increasing the reduced VAT rate instead of the standard rate does not change the workings of a fiscal devaluation. However, it is more efficient in the sense that it makes the overall tax system more efficient as welfare gains can be realised through base broadening.

III. Literature Review: Results of Quantitative Analyses on Fiscal Devaluations

There exists a large body of literature on the economic effects of fiscal devaluations. Studies have been conducted for single countries, as for example for Austria, France, Germany, Italy, Portugal and Spain, but also for country groups, such as the EU-15- and EU-27, a group of Southern European Economies and the group of OECD countries. In most cases, studies are simulation-based, meaning that they rely on a theoretical, general equilibrium model of the economy. Only a small number of studies are econometric studies. Research has primarily focused on evaluating the impact of a fiscal devaluation on GDP, employment and the trade balance, both in the short- as well as in the long-term. Table 2 presents an overview of the results of some quantitative studies on fiscal devaluations.

Switching labour for consumption taxes can lead to an increase of GDP between 0% and 1.04% in the short-term and between 0.1% and 0.7% in the long-term. The effect of employment does not exceed 0.9% in the short- as well as in the long-run. Regarding the trade balance, most of the studies suggest that fiscal devaluations can improve the export performance in the short-run. However, model-based and econometric studies differ in the magnitude of the effect. Model-based studies predict a rather small effect of at most 0.4% of GDP, whereas econometric studies have estimated an improvement in the trade balance of around 4% of GDP for Portugal (Franco 2011) and the Eurozone countries (de Mooij and Keen 2012). In the long-run, the positive effect on the trade balance vanishes and can even turn into negative. Some studies found that a fiscal devaluation can have a negative impact on the trade balance already in the short-run (IMF 2012a, CPB 2013). Overall, the benefits of a fiscal devaluation on output, employment and the trade balance are likely to be small relative to the size of macroeconomic imbalances. To have marked effects, large shifts are likely needed. It has been estimated, for example, that a fiscal devaluation of roughly 6 percent of GDP would have been needed to correct – temporarily – the 1 percent trade balance deficit in the Southern European economies in 2012 (Engler et al. 2013).

Analysing fiscal devaluations in an economic and monetary union could be of particular interest because of two reasons. First, in a system of fixed exchange rates the effects of a fiscal devaluation are more pronounced, as they cannot be offset by endogenous changes in the nominal exchange rate. Second, spill-over effects to other member states can arise due to the non-cooperative character of a fiscal devaluation. Both effects work in the opposite

direction. In principle, a fiscal devaluation could lead to an appreciation of the nominal exchange rate due to the interaction between fiscal and monetary policy and thus weaken the gains of the reform on external competitiveness. This effect is absent in a monetary union, which renders the option to implement a reform more attractive. However, the short-term gains of a fiscal devaluation on competitiveness will be lower the more countries engage in this policy simultaneously. As simulation studies suggest that the induced monetary effects are small relative to the real effect⁷, spill-over effects appear to be the more relevant factor that should be taken into account in a monetary union. Spill-over effects are likely to affect output in other member states at least in the short- and medium-run. Engler et al. (2013) find that a fiscal devaluation in the Southern European Economies (SEE) increase output in the Central Northern European economies (CNEE) in the short-term, despite the expenditure switching effect. In the medium-term, output in the CNEEs falls up to -0.3% until it slowly adjust back to the pre-shock level in the long-term. While a unilateral implementation of a fiscal devaluation is the best option from a single country's perspective, a simultaneous implementation by several countries benefits the union as a whole, by shifting the tax system to a less distortive one and by supporting long-term economic growth. To support the economic rebalancing between member states of the monetary union, the best option, however, would be to implement such a reform first in countries with large initial external imbalances. An interesting topic for future research could be to analyse the effect of a fiscal devaluation for devaluating countries if other members of the monetary union simultaneously engage in a "fiscal appreciation".

The results of simulation-based and econometric studies should, nevertheless, be interpreted with caution. The effectiveness of a fiscal devaluation depends on various country-specific features, such as the degree of price and wage rigidities and price pass-through, the elasticity of labour supply, the size of the economy, its trade openness and the share of labour as variable production input. In theoretical studies, these features are calibrated to a particular country or country group and thus results cannot be easily transferred to other countries under consideration. The different outcome in the effect on the trade balance, for example, can be explained by the different quantification of price and demand elasticities, which influence the two opposing effects that a fiscal devaluation has on the trade balance. On the one hand, a

⁷ Simulating a revenue-neutral tax shift from labour to VAT (by 1% of GDP) for the whole euro-area, the euro exchange rate would appreciate by only 0.38% (CPB 2013).

fiscal devaluation stimulates net exports by reducing the relative export price. On the other hand, it increases imports by the expansionary effect on domestic demand. Depending on the calibration of price and demand elasticities, one of the two effects outweighs the other and the overall effect on the trade balance is either positive or negative. Empirical estimations have their caveats too. Policy endogeneity, for example, is a well-known problem that can distort estimation results in many ways. One example is the case of omitted variables. For example, if a country adopts a fiscal devaluation and at the same time other policy measures designed to support exports and employment, the estimated effect of the fiscal devaluation is overestimated if these additional measures are not included in the set of explanatory variables. Policy endogeneity is difficult to address in a fully satisfactory way and should be kept in mind when interpreting empirical results.

Overall, empirical findings suggest that fiscal devaluations can indeed have useful effects on macroeconomic performance by increasing output, employment and net trade in the short-term. However, the effects are small in magnitude relative to the size of the external imbalances. While effects on GDP and employment are likely to be persistent, the initial improvement in the trade balance vanishes in the long-run. In the context of the euro area, in which international spill-over effects should be taken into account by reforming countries, it would be necessary to implement such reforms first in countries with the most urgent need for short-term economic adjustment. A fiscal devaluation is not an effective tool by itself to address structural divergences between countries as the expected effects of such a reform are likely to be non-sufficient to correct external imbalances. However, it should and has not been ruled out as a viable policy tool to at least accelerate real adjustments, in particular in those countries which need to correct imbalances most urgently.

Table 2: Overview of the results of quantitative studies on the effects of fiscal devaluations ¹⁾

Country	Source	Method ²⁾	GDP (%)		Employment (%)		Trade Balance (% of GDP)	
			ST ³⁾	LT ⁴⁾	ST	LT	ST	LT
EU15	EC 2006	M	-0.1 to 0.5	0.4 to 0.7	0.1 to 0.7	0.5 to 0.9	-0.2 to 0	-0.1 to -0.2
Germany	EC 2008	M	0.1 to 0.2	0.2	0.1 to 0.3	0.2		
EU27	EC 2010	M		0.2				0
Portugal	EC 2011	M	0 to 0.2	0.3 to 0.7	0.2 to 0.3	0.4 to 0.7	0 to 0.2	0
Portugal	ECB 2011	M	0.1 to 0.5	0.2 to 0.3	0.2 to 0.9	0.2 to 0.4	0 to 0.2	0
Italy	IMF 2012	M	0 to 0.2	0.5			0.1 to 0.2	0.2
France	EC 2013 ⁶⁾	M	0.17	0.09	0.7	0.08	-0.09	-0.09
Italy	EC 2013	M	0.36	0.1	0.74	0.11	-0.39	-0.05
Spain	EC 2013	M	0.32	0.12	0.94	0.15	-0.37	-0.06
Austria	EC 2013	M	0.38	0.06	0.49	0.07	-0.54	-0.12
SEE	Engler et al. 2013	M	0.9 to 1.04 ⁷⁾				0.2 ⁷⁾	-0.05
France	Klein and Simon 2010	M	-0.1	0.1	0.2	0.3	0.1 ⁵⁾	0.1 ⁵⁾
France	Heyer et al. 2012	M	0.1	0.3	0.2	0.3	0.4 ⁵⁾	0.3 ⁵⁾
OECD	Arnold 2008	E		0.7				0
Portugal	Franco 2011	E					4	
Eurozone OECD- countries	De Mooij and Keen 2012	E					4.0	~0
Non- Eurozone OECD countries	De Mooij and Keen 2012	E					2.8	~0

1) Revenue shift from (E)SSC to VAT worth 1% of GDP for model based simulations. Across-the-board (E)SSC cut. Effects on GDP, employment and the trade balance relative to the baseline scenario. 2) M=model-based simulations. E=Econometric results. 3) Short-term: 1-3 years, EC 2013: peak value in the first 9 years 4) Long-term: 5-10 years. 5) Effects on net exports. 6) Results of the NiGEM model for short-term dynamics and results from IHS model for long-term dynamics. 7) Peak effect.

Sources: Koske (2013), IMF (2012), EC (2013a), Engler et al. (2013)

IV. What Has Been Done Since the Crisis? Fiscal Devaluations in the Euro Area

Over the last decades, only a few countries carried out standard fiscal devaluations. Well-known examples are Italy (three devaluations in the 1970s), Denmark (1988), Sweden (1993) and more recently Germany (2007). In the case of Denmark, it has been estimated that the reform increased price competitiveness by 5%, measured by relative export prices (IMF 2012). In general, however, it is rather difficult to evaluate the net effects of such reforms on economic growth and competitiveness. In the case of Germany, for example, the improvement in employment also reflected the impact of several years of wage restraint that followed the labour market reforms of 2002-2005. In this section, it will be investigated which members of the euro area have implemented fiscal devaluations in the aftermath of the economic crisis.

During the last years, fiscal devaluations have been considered mostly for deficit countries of the southern periphery of the euro area. Such a reform was part of the economic adjustment program agreed with the Troika (ECB, EC, IMF) for Portugal, which, in the end, was abolished by the government. In the adjustment programs for Greece and Ireland a tax shift in form of a standard fiscal devaluation was not explicitly recommended. However, other measures aiming to increase cost competitiveness were agreed upon, such as a reduction of the minimum wage, public sector wage cuts, a strengthening of wage-setting mechanisms and measures to enhance competitiveness in oligopolistic markets, which should lead to a decrease in mark-ups⁸. In context of the European Semester⁸, the European Commission has recommended a tax shift in form of a fiscal devaluation (shift from labour to consumption taxation) to Belgium, France, Germany, Italy, Latvia and Spain between the years 2011 and 2014.

⁸ Measures to increase cost competitiveness, other than decreasing ESSCs:

- A reduction of the public sector wage bill (leading downward pressure on wages)
 - It has primarily been implemented to reduce public expenditure. However, public sector wage moderation can improve the competitive position as well by putting downward pressure on private sector wages and thus strengthening price competitiveness. As workers shift their labour demand from the public to the private sector to offset the fall in income, the private sector wage level decreases, as well as firms' production costs leading to a real exchange rate depreciation that helps restoring competitiveness (EC 2011a).
- Decrease in mark-ups in oligopolistic markets (leading lower prices for goods and services)
- Decrease in wage minima (leading downward pressure on wages)
- Improve wage bargaining system (leading to increased downward wage flexibility)
- Agreements on wage moderation with social partners (leading to downward pressure on wages)

Despite much discussion, no country has yet undertaken a substantial fiscal devaluation during the last four years. In most cases, reductions in ESSCs and VAT hikes in the years following the economic crisis were not implemented simultaneously and appear to have been considered as two separate elements: the first one to consolidate public finance and the latter to create incentives for employment and to safeguard jobs. Only France and Spain have explicitly introduced the concept of a fiscal devaluation in political debates and already implemented some changes to their tax system that contain elements of a fiscal devaluation. For the remaining countries receiving a recommendation for a tax shift towards consumption, the following can be observed for the years 2008 until 2013 (Figure 2 and 3): In Germany and Belgium, employers received some relief in labour taxation (reflected in a reduction in the ESSC tax wedge, which is defined as the share of ESSCs in total labour costs), while the standard VAT rate remained unchanged and excise duty rates increased. In Italy, both the standard VAT rate and excise duty rates increased during the same time period, but the tax burden on labour did not decrease⁹.

As a tax shift towards consumption can be implemented as a standard fiscal devaluation, it should be noted that Germany is not a candidate for a fiscal devaluation in terms of relative competitiveness and employment. Although the tax wedge on labour is high and there is still room to increase consumption taxes and to revise inefficiencies in the system of reduced VAT tax rates, the tax shift could be structured in a way such that spill-over effects do not reduce or offset the positive effects of fiscal devaluation reforms in deficit countries. It could be envisaged, for example, to lower the SSC rate of employees or the PIT rate instead of the ESSC rate, which are likely to be "trade-neutral", i.e. they do not seem to affect relative export prices in the short-run¹⁰.

⁹ In fact, Italy could have been considered to have implemented a fiscal devaluation by financing targeted reductions in employer's labour cost through a VAT hike. The measures were implemented in the context of the fiscal consolidation packages as from 2012. However, the extent of the tax shift is considered to be fairly modest, leaving the effective tax rate on labour costs more or less unchanged (IMF 2012b). As taxes on commercial property were increased at the same time, production costs might have increased overall, actually worsening external competitiveness of Italian firms.

¹⁰ In the long-run, the effect should be the same regardless of whether the tax cut applies to the PIT, employees' or employee' SSCs. However, in the short run, the ESSC cut directly reduces production costs, while the impact on labour cost is less pronounced reducing PIT or employees' SSC, because wages are set in gross terms (including PIT and employee SSCs, but excluding employer SSCs) and in general temporarily fixed by employment contracts.

Figure 2: ESSC wedge and total tax wedge (share of ESSC as a percentage of labour costs and income tax plus total social security contributions as a percentage of labour costs)

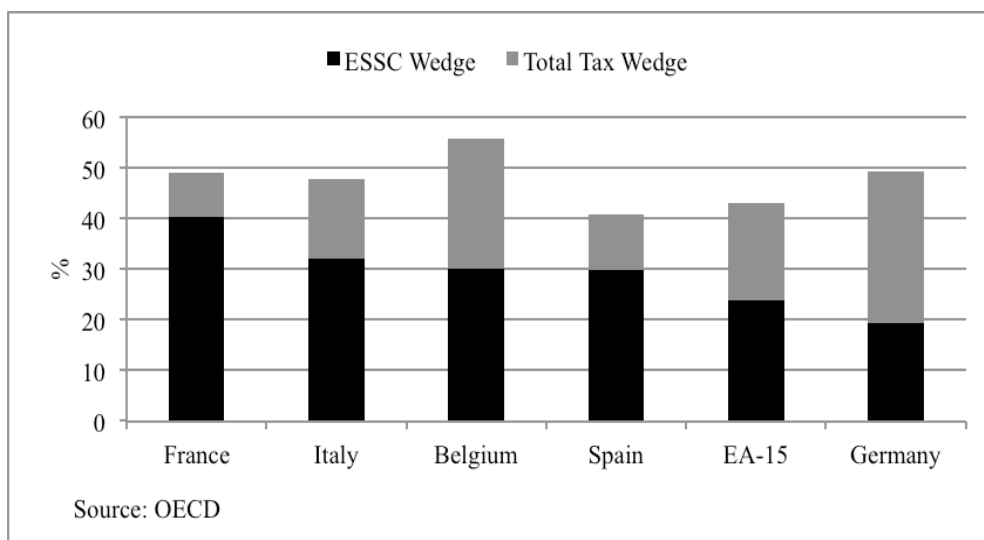
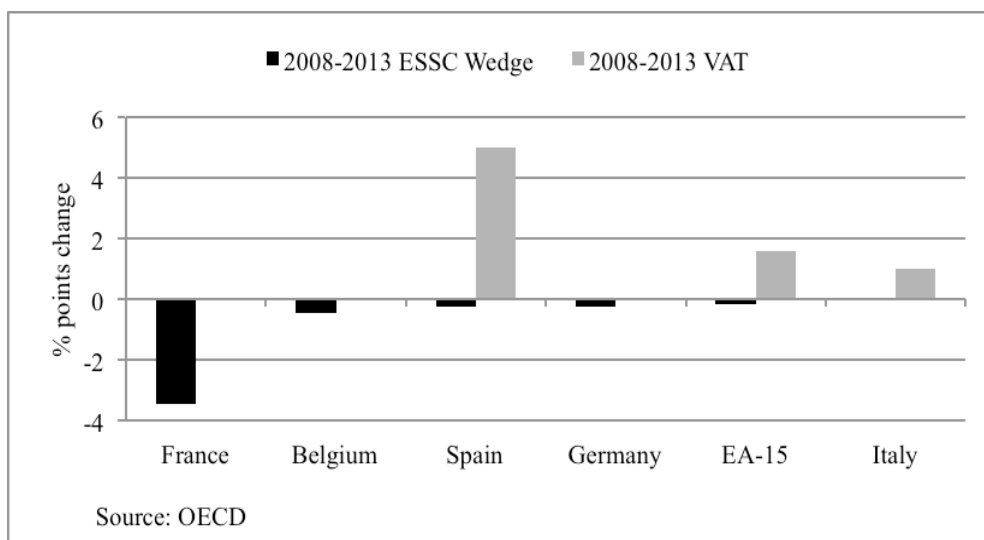


Figure 3: Changes in the ESSC tax wedge and the VAT standard rate between 2008-2013



The remainder of this section will thus focus on France and Spain, where fiscal devaluation like tax shifts have been implemented or announced for the coming years.

- France:

In France, the option for a fiscal devaluation has already been discussed for several years. In early 2012 the centre-right government approved the so-called "Social VAT", which would have lowered ESSCs and increased the VAT rate from 19.6% to 21.2%. The reform, however, was cancelled only a few months later by the newly elected centre-left government. The political debate about increasing cost competitiveness of French companies through a fiscal devaluation regained momentum with the publication of the Gallois report in 2012¹¹. Analysing the steady loss in cost competitiveness, the report called for bolt structural reforms to boost external trade, job creation and economic growth. In 2013, the French government presented a tax credit for competitiveness and employment (*Crédit d'impôt pour la compétitivité et l'emploi*, CICE). The CICE is a tax credit on payroll taxes applying to wages not exceeding 2.5 times the French minimum wage (thus covering wages of around 82 percent of workers). The credit rate of the CICE was increased from 4% to 6% as of 2014. Although all firms regardless of status or sector can apply for the credit, it is conditional to particular investments such as in R&D, training, recruitment, development of new markets and energy efficiency¹². In early 2014, the CICE was complemented by the "Responsibility and Solidarity Pact" (*Pacte de Responsabilité et Solidarité*, RSP) which foresees further reductions in employers' labour tax burden by 2017. The package includes *inter alia* cuts in employers' social security and family allowance contributions for low-wage workers. Altogether the reform packages are worth EUR 30 billion of labour tax cuts (1.5 of GDP). Two thirds are allocated to the CICE and the remaining EUR 10 billion to the RSP. The CICE will be financed half through an increases in the VAT rate and environmental taxes and half through a reduction in public spending. The remaining 10 billion are allocated to the RSP, of which EUR 4.5 billion will be spent on low wages (between 1 and 1.6 times the minimum wage), EUR 4.5 billion on medium wages (between 1.6 and 3.5 times the minimum wage) and EUR 1 billion on the self-employed. Regarding consumption taxation, as of 2014, the standard VAT rate was raised from 19.6% to 20%, while the reduced rate increased from 7% to 10%. These measures are expected to generate around EUR 6.4 billion revenues. In addition, a carbon tax was introduced and some additional measures in the area of environmental taxation were enacted, though with low budgetary impact (the extension of the scope of application of

¹¹ Louis Gallois: *Pacte pour la compétitivité de l'industrie française, Rapport au Premier ministre 5 novembre 2012*.

¹² Loi n° 2012-1510 du 29 décembre 2012 de finances rectificative pour 2012, article 66.

the *Taxe Générale sur les Activités Polluantes*, a tax on polluting activities, and the strengthening of the *bonus/malus* system for car taxation).

- Spain:

Spain implemented relatively small changes in the SSC system, which were targeted to the most disadvantageous groups on the labour market. In 2009, Spanish authorities introduced abatements and reductions in ESSC for employers that hire unemployed workers with children. The national "Youth Employment and Entrepreneurship Strategy 2013–16", adopted in March 2013, incorporated targeted hiring subsidies for young people in the form of reductions in or temporary exemptions from ESSCs. In early 2014, a flat social security rate of EUR 100 for new permanent employment was introduced, applying to employees hired between February and December 2014. In early 2014, Spain's government discussed proposals for a fiscal devaluation, prepared by a committee of experts selected by the Minister of Finance (*Comisión de Expertos Para la Reforma del Sistema Tributario Español*). However, recently announced taxation reforms do not include any further reduction in the ESSCs (but in PIT). With regard to consumption taxation, Spain increased the standard VAT rate by 2 and 3 percentage points in 2010 and 2013 respectively, and the reduced rate from 7% to 10%.

V. What can be expected from the reforms? The Case of France and Spain

France and Spain could both benefit from the effects of a fiscal devaluation, in terms of increasing competitiveness, output and employment. Spain recorded a persistent current account deficit since entering the monetary union and France's current account balance has been gradually weakening since the mid-2000s (Figure 4). However, the underlying reasons for the weak external position differ¹³. While most of current account deficit is due to a deterioration in the trade balance in both countries, developments in import and export performance are different (Figure 5). In Spain, the trade deficit arose due to a surge in domestic import demand, triggered by high capital inflows and a low interest rate

¹³ For a more detailed explanation on the evolution of current account deficits and recent developments see EC 2014a, EC 2014b and Kang and Shambaugh (2013).

environment. The export share, instead, remained almost stable over the last decade. In the years following the crisis, import contraction has mainly contributed to an improvement in the trade balance. In addition, the process of internal devaluation has advanced in Spain since 2009. Wage moderation and some productivity gains have led to a reduction in the labour costs, both, in the export and import sector, thereby improving its external price competitiveness. A tax shift away from labour could complement the ongoing progress.

In France, the deterioration of competitiveness in the export sector is much more pronounced than in Spain, losing almost 40% of its world export share between 2000 and 2013. Price, as well as non-price developments such as the export product mix and quality have contributed to the poor export performance of French goods. In this respect, making the tax credit of the CICE conditional on particular investments, such as in R&D points in the right direction to foster the non-price competitiveness of the French industry. Improving price competitiveness remains an equally important economic challenge. France is among the euro area economies where the cost of labour is the highest. In particular, the high tax burden on labour reduces firms' profitability. Although the CICE and RSP reduce the burden of labour taxation, the impact on the trade balance can be expected to be relatively modest as non-exporting firms will benefit more from the tax credit, which tend to employ lower-skilled workers and thus generally distribute lower wages than exporting firms (Guillo and Treibich 2014).

Figure 4: Current account developments in France and Spain

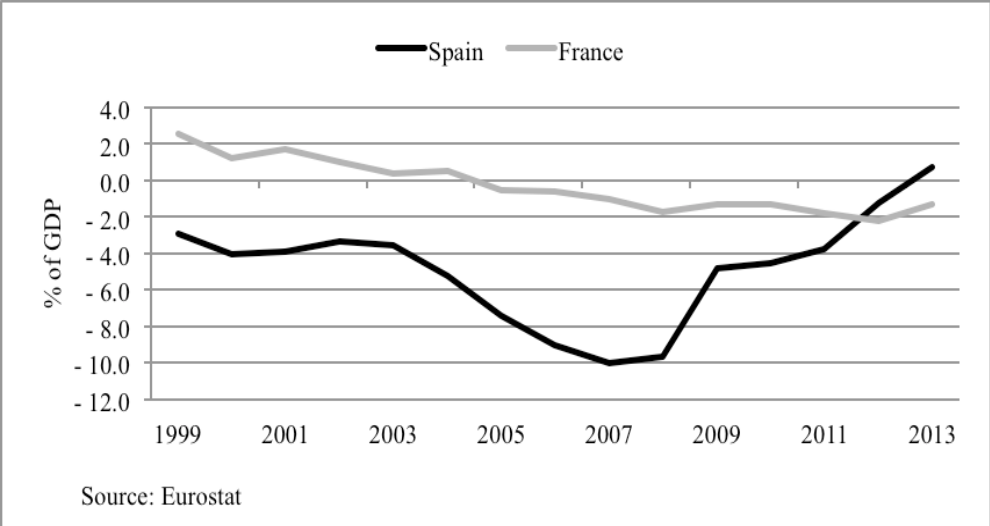
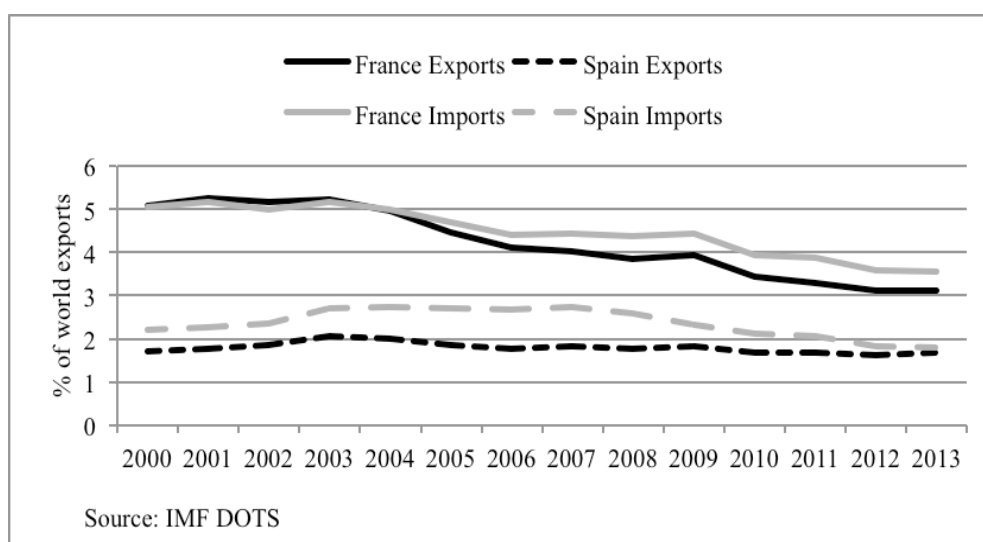


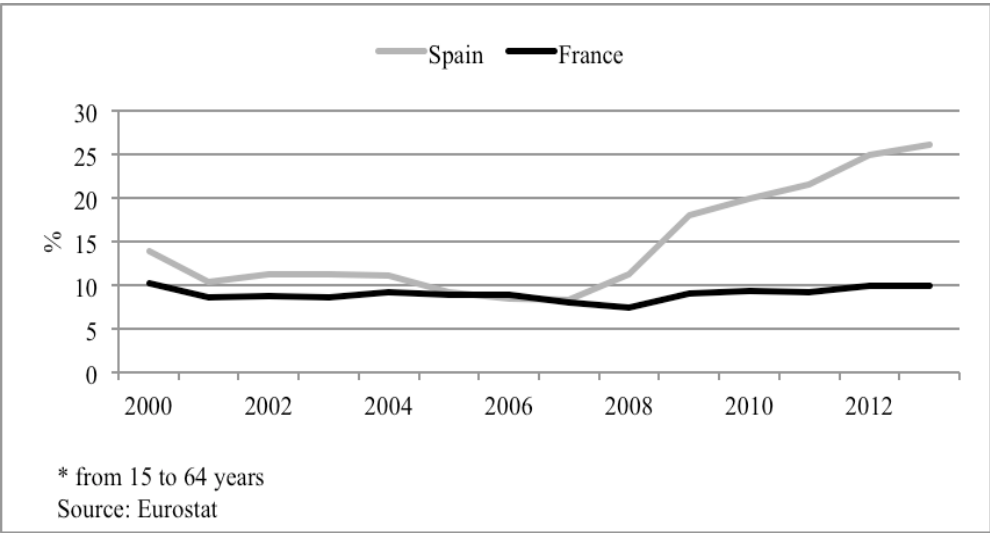
Figure 5: Export competitiveness in France and Spain



With the economic crisis, unemployment has worsened in both countries, although the problem is more pronounced in Spain (Figure 6 and 7). In 2013, Spain recorded the second highest unemployment rate (after Greece) for total and youth unemployment within the euro area amounting to 26.2% and 55.5% respectively. Although the total tax wedge is only slightly above the euro area average (1.6 percentage points above EU-17 average in 2013), the ESSC burden is relatively high (around 6 percentage points above EU-15 average in 2013) allowing some room for tax cut driven employment policies. However, a standard fiscal devaluation would not be the key to address Spain's unemployment difficulties, which are more of a structural nature than taxation driven. In particular, one of the root causes for youth unemployment is a geographical and skill mismatch between labour demand and supply. In order to reduce the unemployment rate by 3 percentage points, a substantial tax shift of more than 10% of GDP would be needed (EC 2014c). However, if ESSC cuts are accompanied by other measures to decrease production costs, such as an agreement on wage moderation between the government and social partners, employment effects are estimated to be significantly stronger (IMF 2013b). In France, by contrast, the unemployment rate is high, reaching 9.9% for total unemployment and 16.4% for low-skilled unemployed in 2013, but both rates are still below the EU-27 and euro area average. According to some simulation studies, the CICE is expected to increase GDP by 0.1 to 0.3 percentage points and to create around 130 000 to 150 000 new jobs in the short run (next 2 to 4 years) (Espinoza and Pérez

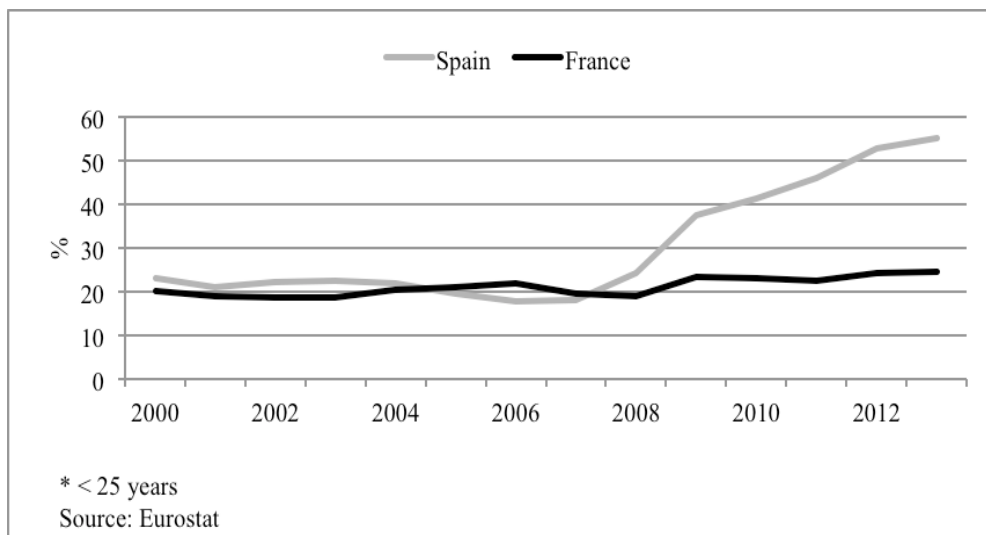
Ruiz 2014, Plane 2012). The combined effect of the CICE and the targeted RSP, if unfinanced by spending cuts, is estimated to boost output by 0.5 percentage points and to create around 290 000 jobs in the short run, which would reduce the unemployment rate by around 1.2 percentage points. In the long-run, unemployment is estimated to fall by around 2.4 percentage points (around 600 000 jobs), if ESSC cuts are not targeted and the reform remains unfinanced by spending cuts (Espinoza and Ruiz, 2014)¹⁴.

Figure 6: Unemployment rates in France and Spain*



¹⁴ The long-run effects on employment are more optimistic than the ones predicted by CPB (2013), Klein and Simon (2010) and Heyer et al. (2012) (see Table 2). According to the simulation studies, a tax shift worth 1.5% of GDP would increase employment between 0.13% and 0.4%. Differences in the results can stem from the underlying model parameterization.

Figure 7: Youth unemployment rates in France and Spain*



Overall, it is good news that the reforms will lower the high labour tax burden in both countries. The reforms can be a measure to support short-term recovery but given the uncertainty about the expected magnitude of trade and employment effects, they are clearly not a substitute for structural reforms that are needed to address the root causes of macroeconomic imbalances. Economic gains of fiscal devaluations are not only likely to be small relative to the structural problems deficit countries face but also in terms of political feasibility. The political complexity surrounding tax reforms, in particular in context of the economic crisis, is a critical issue regarding the feasibility of fiscal devaluations and mainly answers to the question why other deficit countries refrained or abolished such reforms and why a "downward spiral of fiscal devaluations" could not be observed during the last years. The next chapter will thus elaborate on the political economy of fiscal devaluations and addresses key practical issues that determine the effectiveness of such a reform.

VI. More to come? On the Political Feasibility of (Future) Fiscal Devaluations

While national governments implemented just marginal and episodic tax reforms during the years preceding the euro area crisis, they introduced a wide range of tax reforms in the years following the crisis (Bernardi 2014). Naturally, the question arises why tax shifts in form of a

fiscal devaluation were implemented only in some deficit countries and why reforming countries like France and Spain did not implement measures at an earlier stage.

Political variables and country specific institutional features play a decisive role in shaping tax reforms (Castanheira, Nicodème and Profeta 2011). In general, it is much more difficult to agree politically on a real depreciation of the exchange rate than on a nominal one, which would be the responsibility of an independent central bank that can react to economic developments relatively quickly and flexible. Political agreements, on the contrary, on how to refinance ESSC cuts are subject to a slow and complex decision making process, rendering a fiscal devaluation less suitable as an immediate fire-fighting measure in times of crises. In addition, policy decisions on tax reforms were constrained by external factors over the last years, which defined government budget and debt stabilization as the overriding objective of tax policy. The Stability and Growth Pact, for example, implied for euro area countries to lower the nominal fiscal deficit below 3% within a short space of time. Deviations from fiscal austerity were considered to further exacerbate financial tremors about debt sustainability and the cohesion of the monetary union. Thus, at a time when fiscal consolidation is pursued rigorously, it seems comprehensible that the fiscal implications of a tax reform are an important factor in determining the feasibility of the reform. In fact, even if fiscal devaluations are designed to be budgetary neutral *ex-ante*, the *ex-post* budget neutrality of a fiscal devaluation is not guaranteed. Regarding France and Spain, government debt levels and fiscal deficits still remain high. In 2013 budget deficit amounted to -4.3% and -7.1% of GDP and government debt stood at 93% and 94% of GDP in France and Spain respectively. Thus, room for fiscal manoeuvres is limited. In France, the government is expected to reduce public spending by EUR 50 billion by 2017, as laid out in the Stability Program and National Reform Program 2013-2017. If spending cut objectives are deferred and reforms remain unfinanced through spending cuts, the CICE is expected to worsen the fiscal balance by -0.2% of GDP in 2014 and by -0.4% between 2015 and 2017 (excluding the RSP).

Although public debt levels still remain worryingly high in some deficit countries in the euro area, economic recovery is slowly resuming, opening the opportunity for governments to put higher priority to employment and external competitiveness. Still, fiscal devaluations are difficult to implement in practice, as they can suffer – like reforms in general – from the *status quo bias*, i.e. the resistance to change from an existing tax system to another. Increasing consumption taxes are unpopular among voters and risk social acceptance and support of the

reform. Typically, tax shifts towards consumption have a regressive impact and reduce the real disposable income of households, if they remain uncompensated by transfers (CPB 2013). Although targeted ESSC cuts might reduce the regressive impact of fiscal devaluations, effects on long-term productivity should be taken into account as such measures can influence the supply and demand for medium- and high-skilled workers (CPB 2013).

For voters, these "costs" of a fiscal devaluation, i.e. the distributional impact, are more visible than competitiveness and employment gains. The gains of the reform are not only more difficult to identify, but also uncertain. One of the critical mechanisms behind a fiscal devaluation is the pass through of lower labour costs to producer prices. If lower production costs do not (fully) translate into lower export prices, export competitiveness will not improve. The case of Portugal, for example, a fiscal devaluation was not implemented because the reform was strongly opposed by critics claiming that firms would pocket lower contribution to payroll tax.

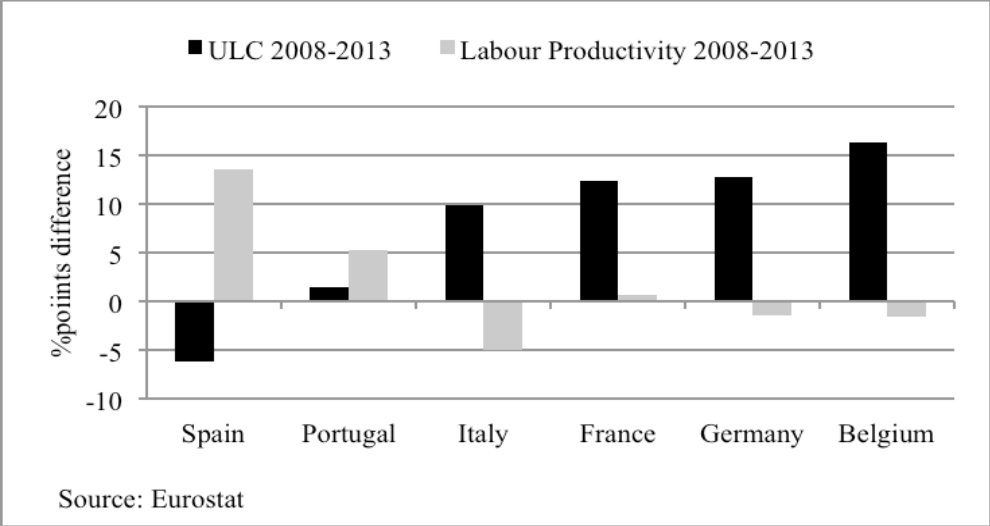
As governments in deficit countries have increased standard VAT rates already over the last years (in Greece by 4%, in Italy by 2%, in Portugal by 3% and in Spain by 5%), room for further hikes is limited and there is a general (legally non-binding) agreement between EU Member States to increase the standard VAT rate not beyond 25%. Furthermore, as tax fatigue among the population may set in, further increase could also aggravate the problem of tax compliance. Alternatively, it can be considered to align reduced VAT rates to the standard rate or to remove existing exemptions instead. This option is not only in line with the EU's tax policy recommendations (as laid out in the Annual Growth Survey), it might also increase the efficiency of a fiscal devaluation. The standard VAT rate only covers a fraction of consumption spending. Theoretically, however, the VAT hike has to apply uniformly to all domestically produced goods, including non-tradables, to replicate the effects of a nominal exchange rate depreciation (Fahri et al 2012)¹⁵.

In addition, since 2008 some adjustment progress in cost competitiveness has been under way in some deficit countries in the euro area through measures other than a fiscal devaluation. In Spain, for example, nominal unit labour costs decreased by 6 percentage points between 2008 and 2013. The largest contribution to improved cost competitiveness has stemmed from

¹⁵ Alternatively, the reduction in the payroll tax should be extended only to the industries that face an increase in the VAT (Fahri et al. 2012).

increased average labour productivity, reflecting to some extent labour shedding in low productivity sectors. Public sector wage cuts have also supported nominal wage adjustment, albeit to a limited extent. (EC 2013).

Figure 8: Nominal Unit Labour Costs (Total Economy) compared to Developments in Labour Productivity between 2008 and 2013



VII. Conclusion

The recent economic and financial crisis was a crucial turning point for many EU countries to tackle their competitiveness loss, which has gradually built up over the last decades. Regardless of the varying underlying causes of external imbalances, fiscal devaluations have been considered as a viable fiscal policy instrument to support real adjustment as they can replicate the effects of nominal exchange rate depreciations. Despite much discussion, no country has yet undertaken a substantial fiscal devaluation after the crisis hit in 2014. During the last years, reductions in ESSCs and VAT hikes were in general not implemented simultaneously and appear to have been considered as two separate elements: the first one to consolidate public finance and the latter one to create employment incentives and to safeguard jobs. Only France and Spain have explicitly introduced the concept of a fiscal devaluation in political debates. France is about to become the first country to undertake a textbook fiscal devaluation by introducing the CICE and RSP, which are expected to boost output by 0.5

percentage points and to reduce the unemployment rate by around 1.2 percentage points in the short-run. Long-term unemployment could eventually fall by around 2.4 percentage points. While external competitiveness is a more critical issue of concern in France, Spain mainly suffers from a historically high level of unemployment. To have a substantial effect on employment, however, a large shift from labour to consumption taxes is likely needed.

Both countries would benefit from reducing the relatively high tax burden of employers' social security, thereby making the tax system more efficient. But given the small expected magnitude of effects and the uncertainty surrounding a successful implementation of the reforms – ex-post budget neutrality, social acceptance of further increases in consumption taxation, worsening of tax compliance and implications for long-term productivity in the case of targeted labour tax reductions – fiscal devaluations are not a substitute for structural reforms. With the need for short-term firefighting significantly reduced over the last year, setting out a clear agenda for structural reforms to improve external competitiveness and long-term growth and ensuring the full implementation of measures remain superior to frequent, small scaled and temporary changes in the tax system.

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