

Fiscal Devaluation: Efficiency and Equity

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The economic literature has highlighted the desirability of shifting taxation from distortionary levies like taxes on labour to less distortionary ones like value-added taxes in order to strengthen economic growth and foster employment. Such a tax shift is discussed as one policy option to engineer a (fiscal) devaluation in some EA member states with elevated domestic labour costs. Despite their favourable effects on growth, fiscal devaluations are very often opposed because of equity considerations. It is argued that shifting taxation from labour to consumption is regressive as it favours households with a comparably high savings rate over those with a low savings rate and that such a tax reform is associated with a redistribution of income from relatively poor to relatively rich households. This view has recently been challenged in the literature arguing that a consumption tax is an implicit tax on capital and in particular distributed profits plus interest income. In particular, it is argued that theoretical results backing the regressivity claim are based on models which are not able to capture realistic wealth distributions. The often used overlapping generation models cannot generate large wealth discrepancies as they do not allow for bequests. Dynamic Stochastic General Equilibrium models with infinitely lived agents implicitly would allow for bequests and are therefore more adequate to address this question.

The literature on fiscal devaluations distinguishes between micro-simulation studies and general equilibrium analysis. The advantage of micro simulation studies is their level of detail concerning the income distribution. However, those studies tend to ignore how the tax reform affects prices and quantities in the economy. General equilibrium analyses do not seek to map a realistic household income distribution, but instead focus on coherent modelling of different sources of income such as income from labour, assets, transfers, benefits etc. Moreover, general equilibrium analysis accounts for price and quantity adjustments e.g. in the goods and labour market in response to a reform. Micro-simulation studies find evidence that a tax shift is only beneficial to the upper deciles of the income distribution. This result can be explained by the large share of the non-working population in lower deciles of the income distribution. Not working, these households would not profit from a reduction in the tax burden on labour. Furthermore, micro-simulation studies often focus on disposable income instead of total consumption spending which might be a more adequate indicator for permanent income effects of the tax shift. Indeed, micro studies focussing on total consumption expenditures point to a more favourable distributive effect of a fiscal devaluation.

General equilibrium analysis often suffers from an unrealistic assumption on the distribution of wealth. The frequently used overlapping generation models cannot generate large wealth discrepancies as they do not allow for bequests. Dynamic Stochastic General Equilibrium models like the European Commission's QUEST3 model with infinitely lived agents implicitly would allow for bequests and are therefore more adequate to address this question. QUEST3 distinguishes between

two types of households, namely liquidity constrained households who receive only income from labour and transfers and financially unconstrained households who receive labour income, transfers and income from financial wealth (government bonds) and real capital. Although this does not allow for a detailed analysis of distributional effects across income and wealth deciles, it does show how the tax shift affects real (permanent) income of households that only rely on labour and transfer income and households that in addition receive income from financial wealth. Furthermore, the QUEST3 model allows for a separate analysis of how the tax shift affects the several categories of income: wage, benefit, transfer, profit and interest income.

This paper highlights some attractive properties of tax shifts from labour to consumption. First, we confirm the well-established positive effects on growth and on the external balance. Second, such a tax reform has progressive effects on the distribution of income between workers and capital owners in the long run, while the reform is regressive when we compare the effects of labour and transfer income. This is due to the fact that such a tax reform shifts taxation away from labour to all other sources of income. Concerning the ratio of net wage to income from financial and non-financial assets specifically, we find that the tax shift is regressive in the short run¹ but progressive in the long run if it is enacted by reducing employers' social security contributions but is progressive already in the short run if it is enacted by reducing labour taxes. Concerning the ratio between net wage income and net transfer income the tax shift is regressive, especially in the case in which transfer income recipients are not compensated for the increase in the VAT. This effect is partly alleviated by a positive employment effect which allows unemployed workers into employment. Third, in contrast to monetary devaluations the employment and GDP effects of a fiscal devaluation can be permanent. Fourth, fiscal devaluations can mimic the effects of a labour market reform by increasing the gap between net wages and net benefits. Fifth, the simulation results highlight the trade-off between higher efficiency gains and equity considerations with regards to transfer and benefit recipients: the growth and employment gains are smaller if transfer and benefit recipients are explicitly compensated for their purchasing power losses, owing to the increase in VAT.

¹ With "short run", we are referring to an extended period of time, in which sticky prices and wages - owing to price rigidities - can adjust. Any time horizon beyond will be labelled "long run".