

TAX REFORM AND COORDINATION IN A CURRENCY UNION

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ABSTRACT. We propose a two-country DSGE model to analyze short-term and long-term impact of a modification of consumption and labor tax rate in one country in a currency union. The model embodies the fact that firms differ in their pricing behavior after a VAT tax increase. Due to the common monetary policy, national tax policies have large spill-overs on the rest of the currency union. Furthermore, a fiscal devaluation is different from a nominal devaluation due to the common monetary policy.

JEL Classification: F56; C12.

Keywords: Fiscal Policy; Monetary Policy; DSGE; Value added Tax; Monetary Union.

RÉSUMÉ. Nous proposons un modèle DSGE à deux pays pour analyser l'impact à court et à long terme d'une modification de la TVA et des cotisations sociales dans un pays de l'union monétaire. Le modèle prend en compte le fait que les entreprises diffèrent dans leur comportement prix après une hausse de la TVA. En raison de la politique monétaire commune, les politiques fiscales nationales ont des externalités sur le reste de l'union monétaire. En particulier, les effets d'une dévaluation fiscale sont différents de ceux d'une dévaluation nominale.

Classification *JEL* : F56 ; C12.

Mots-Clefs : Politique budgétaire ; politique monétaire ; DSGE ; TVA ; Union monétaire.

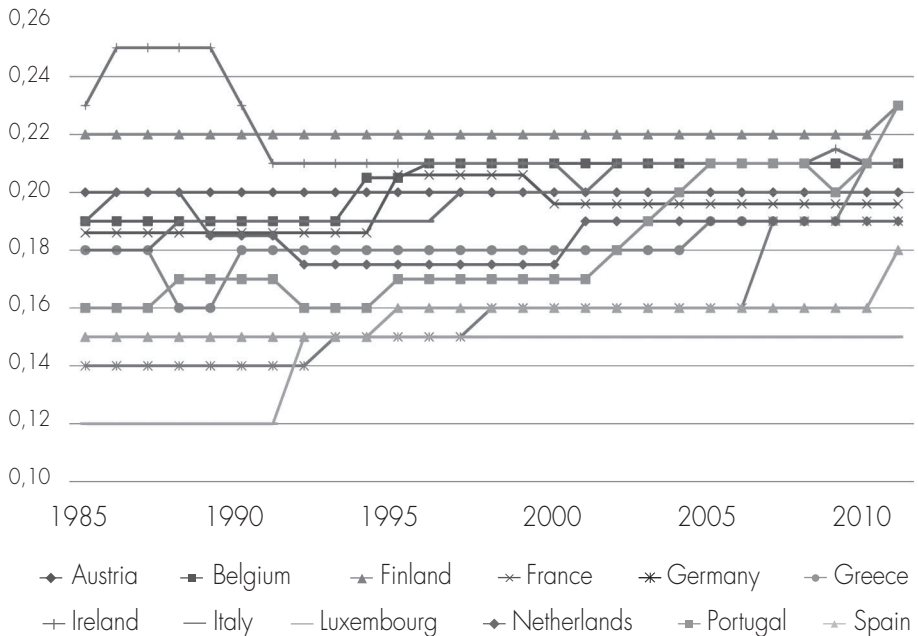
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1. INTRODUCTION

Most of the tax burden in Europe is shared between labor (social contributions) and consumption (VAT); the share of the latter has been growing over the last 25 years (see Figure 1). The consequences of the financial and economic crisis on public finance and the ongoing aging process will require further tax increases in the near future.

Figure 1 – Standard VAT rates in euro area



There is a large literature dealing with the analysis of tax policies from the micro perspective (tax incidence), emphasizing their impact on resource allocation and their redistributive effects² and assessing optimal taxation³. An other approach looks at how a change of the fiscal stance affects the aggregate demand and supply, prices and output⁴. There is now a growing 'policy oriented' literature aiming to close the gap between the two approaches. It is traditionally based on dynamic general equilibrium models including real and nominal rigidities to reproduce short run stylized facts. A recent contribution is Coenen *et al.* (2007) who focus on Euro Area-wide consumption and labor tax reduction using the New Area-Wide Model (NAWM). In a similar vein, Roeger & in't Veld (2006) estimate the impact of shifting taxation from labor to consumption.

2. For instance, Boeters *et al.* (2006) evaluate the long term impact of the 2007 German tax reform and Feenberg *et al.* (1997) address the distributional effect of shifting to a consumption tax.

3. Chamley (1986) on capital taxation.

4. Henry *et al.* (2004) make a comparison between different estimations with macro-models.

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