Fiscal Devaluations in EMU*

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Abstract

We use a small open economy general equilibrium model to analyse the effects of a fiscal devaluation in an EMU country. The model has been calibrated for the Spanish economy, which is a good example of the advantages of a change in the tax mix given that its tax system shows a positive bias in the ratio of social security contributions over consumption taxes. The preliminary empirical evidence for European countries shows that this bias was negatively correlated with the current account balance in the expansionary years leading up to the 2009 crisis, a period when many EMU members accumulated large external imbalances. Our simulation results point to significant positive effects of a fiscal devaluation on GDP and employment similar to the ones that could be obtained with an exchange rate devaluation. However, although the effects in terms of GDP and employment are similar, the composition effects of fiscal and nominal devaluations are not alike. In both cases, there is an improvement in net exports, but the effects on domestic and external demand are quite different.

Keywords: tax mix, fiscal devaluation, nominal devaluation.

JEL: E62, E47, F31.

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