April 25, 2013 3

Harvard University's Gita Gopinath: Stimulating Europe's Growth

by marcobuchbinder

With the troubled European economies struggling to restart their economic growth, while grappling with extreme budget constraints, an up and coming, stellar economist from Harvard has proposed a remarkably simple solution. It is referred to as "fiscal devaluation" and it enables countries to generate growth through exports, without resorting to devaluing their currencies

Meet Gita Gopinath, the 41 yr. old **Professor of Economics at Harvard University**, whose solution was recently implemented by France's President Francois Hollande, as a mechanism to revive France's languishing economy.

Gita, tell us about the concept of fiscal devaluation.

Fiscal devaluation, by its name is an alternative to an exchange rate devaluation that is engineered using fiscal instruments. There are several ways to engineer one. One "remarkably simple alternative" is to increase value added taxes and cut payroll taxes. Countries in the euro zone, who do not have their own currency to devalue, can use the VAT-payroll tax swap to revive growth through exports. By increasing value-added taxes while cutting payroll taxes, a government can affect gross domestic product, consumption, employment, and inflation much as a currency devaluation would. Essentially, the higher VAT raises the price of imported goods as foreign companies pay the levy on the products and services they export to that country. The lower payroll tax helps offset the extra sales tax for domestic companies,

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About Marco

Born in Milano and raised in Italy and the US, Marco has lived in five different countries, speaks four languages and has conducted business in every major region of the world. Marco currently leads EMC Corporation's GTM Equity Investments Group, executing investments and JVs, primarily in the emerging markets.

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reducing the need for them to raise prices. Since exports are VAT-exempt, the payroll cost saving allows producers to sell goods more cheaply overseas, simulating the effect of a weaker currency. And finally, the policy also can help on the fiscal front, as increased competitiveness can lead to higher tax revenue.

What kickstarted the idea?

The original concept behind fiscal devaluation goes back to John Maynard Keynes, who proposed increasing import tariffs and cutting export subsidies as an alternative to a currency devaluation (when countries were on the gold standard). Euro zone rules would disallow any intervention that uses tariffs and subsidies. This is why we push the alternative of VAT and payroll tax changes. It has often been conjectured that fiscal taxes can substitute for currency devaluation, but this has never really been proven. This is what we set out to figure out in our research. Initially we were skeptical that a couple of tax instruments would do the job regardless of the details of the specific economy we were applying it to. To our surprise we did find that indeed a VAT-payroll tax swap worked exactly (not approximately) as a currency devaluation and this was insensitive to a large number of details about the economy.

We started work on this idea a couple of years ago. My co-author, Farhi, is a macro economist working on public finance issues, my other co-author, Itskhoki, is a trade economist and I work on exchange rates. The three of us were able to use each other's expertise to develop the idea.

Are there any initial positive signs resulting from France's implementation?

Well, President Hollande recently has implemented a $27 billion tax cut for French companies and recently, Louis Gallois, former Airbus Chief, was quoted as saying that France was starting to turn the corner in a business-competitiveness report commissioned by Hollande. However, in my opinion, the intervention was too small and not executed as well as I would have liked. The size of the intervention in payroll taxes is too small to make much of an impact and the VAT tax increase has yet to be implemented (You really need to do both at the same time). Further, there have been many other tax increases in France, in recent times, that have the effect of undoing the benefits of a fiscal devaluation. The payroll tax cut is however hailed as the one pro-business development in France in recent times, so that is a good sign.

Which other countries could be prime candidates for fiscal devaluation?

Countries whose central problem is a loss of competitiveness would benefit from a fiscal devaluation. I would say that Spain and Portugal are candidates. Now of course, if everyone did a fiscal devaluation no one gains (same as a currency devaluation). One imbalance that is often pointed out is that Germany runs a trade surplus relative to all other countries in the euro zone. A policy intervention that might be a good contribution for Germany to the euro zone is to do the reverse of a fiscal devaluation. In 2007, Germany raised its VAT and cut payroll taxes. It might consider reversing such moves, so that its competitiveness is realigned with that of the other countries in the euro area.

Finally, how would you describe the EU's current prognosis and how do the next 12 months look from your perspective?

These are interesting times. The one good news that came out of the EU in the past few months was the decline in sovereign spreads for the troubled economies of Spain, Portugal, Greece and even Italy. This was a combination of the "Draghi put" (to stand by the euro at all cost) and the extremely loose monetary policy in the rest of the developed world. Now with the U.S. slowing quantitative easing and with German elections around the corner (September), the risk that sovereign yields will rise again is a real one. With the larger EU economies like France and Italy still stagnant, the impact on these economies of even small increases in yields can be large. We already see a lot of volatility in markets with the decline in quantitative easing in the U.S, so the next few months will be critical to the success of the euro project.

Europe, **Fiscal Devaluation**, **Gita Gopinath**, **Harvard** *Read more from* **Economics**

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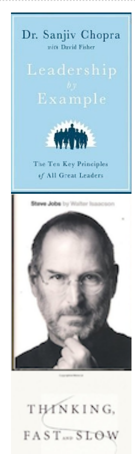

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Christian
Jun 25 2013

Gavin R. Putland (@grputland)
Jul 14 2013

EXTENDING FISCAL DEVALUATION TO PAYG PERSONAL INCOME TAX

Why merely REDUCE payroll tax? Why not ABOLISH it altogether? If the revenue were replaced by VAT, domestic retail prices of domestic products need not rise; embedded payroll tax would be replaced by embedded VAT. Of course retail prices of IMPORTS would rise due to the higher VAT. But domestic consumers would be compensated by better employment opportunities due to abolition of payroll tax.

And why stop at payroll tax? The cost of labour for employers can be reduced further — without reducing employees' "take-home" pay or widening after-tax wage inequalities — by replacing Pay-As-You-Go personal income tax IN THE HANDS OF EMPLOYERS. Employees would continue to receive credit for the PAYG tax withheld by their employers (calculated on their "grossed-up" wages). But businesses, instead of forwarding the withheld PAYG tax to the government, would pay a higher VAT. In the aggregate, the withheld PAYG tax would cover the additional VAT, with no need to raise domestic retail prices of domestic products.

Three advantages would follow from this combination. First, payroll tax and PAYG personal income tax would be completely removed from the marginal cost of labour as seen by employers. That means more jobs, hence more domestic demand for domestic products. Second, the additional VAT, unlike the tax component of the cost of labour, would not feed into export prices. That means more foreign demand for domestic products. Third, because the extra jobs would reduce welfare spending, not all of the lost revenue from PAYG tax would need to be replaced. That would allow a slight FALL in prices of domestic products.

I have suggested this replacement of payroll tax and PAYG tax as a lifeline for indebted nations on the edge of the eurozone — in particular, Ireland: http://t.co/u5BtJd5Nxi .

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Gavin R. Putland (@grputland)
Sep 3 2013

P.S.: See "Fiscal devaluation on steroids" – http://t.co/7WTLA9Bzq3 .

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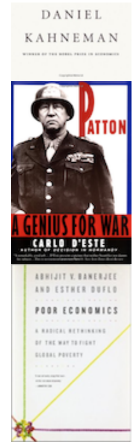

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