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"Supply-Side Economics in an Integrated World Economy"

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This paper examines long-run macroeconomic effects of fiscal policies in the context of a two-country, two-sector dynamic equilibrium model. Numerical simulations quantify the effects of changes in tax and expenditure policies on welfare and macroeconomic aggregates. Some of these simulations aim to examine part of the effects of European debt convergence and tax harmonization envisaged in the Maastricht Treaty and of fiscal consolidation in the United States. The model is calibrated to mimic features of the current stance of fiscal policy in industrial countries such as GDP ratios of government expenditures and tax rates on factor incomes and consumption as well as average growth rates and labor income shares in GDP. This benchmark model reproduces the observed output shares of consumption, investment, net exports, tax revenue, and government transfers.

A comparison of long-run welfare levels shows that in the model the costs associated with the distortions of existing taxes are large, as are potential gains of tax reforms favoring indirect taxes, and that, in contrast, incentives for immigration are small. Although transition costs following a tax reform dramatically reduce the long-run welfare gains, these gains are still larger than existing estimates of those derived from price and output stability, international risk sharing aimed at smoothing consumption, and decreased policy uncertainty.

Consumption taxes generate smaller welfare costs per unit of revenue than factor income taxes. The capital income tax is the least efficient because it distorts savings and lowers the investment rate. These findings imply that proposals to reduce budget deficits partly by shifting the tax system toward heavier capital income taxation may be suboptimal. Although tax policies affect the external balance, a widening fiscal deficit resulting from tax reductions does not always worsen the trade deficit. This is true of the labor income tax but not of capital and consumption taxes.

The effects of changes in government expenditures depend on whether they are uniform across tradable and nontradable sectors and on whether they are financed with distortionary taxes or lump-sum taxes. An expansion of expenditures financed with lump-sum taxes has significant effects when it is uniform across sectors, but not when it is biased toward nontradables. The opposite is true for a consumption tax-financed increase in expenditures.

The model shows that the effects of tax harmonization and public debt convergence on macroeconomic aggregates are small, but the welfare implications are significant. However, tax agreements that focus only on indirect tax harmonization induce incentives for low-tax countries to modify factor income taxes in order to offset welfare losses. Debt convergence results in welfare gains in excess of 4 percent for high-debt countries, with little impact on the performance of low-debt countries.