Effects of Fiscal Devaluation on the Innovation Sector and Market Structure

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Abstract:

After the breaking out of the global financial crisis and the sovereign debt tensions in 2010, fiscal devaluation has come back into view as a suggestion for Southern European countries to regain competitiveness and improve the within-union external imbalances. With governments holding budget constraints neutral, fiscal devaluation discussed in the paper takes the form of a subsidizing on labours, complemented by taxing the consumptions. Standard examples include Value Added Taxes and Employment Social Security Contributions. This paper contributes to the literature by discussing fiscal devaluation's influences on the innovation sector and the intertemporal numbers of firms active in the economy. Starting from a closed economy case, this paper sets a two-sector model and chooses non-CES utility functions. In the case of an increasing relative love for variety, fiscal devaluation leads to procompetitive outcomes: in the short run, markups decrease. In the long run, the number of firms increases, supported by the development of innovation sector, which results in an increase in social welfare. When we open the border, we find that the implementation in one country also has positive effects on its trade partner, so that fiscal devaluation is not a beggar- thy- neighbor policy.

Keywords: Fiscal Devaluation, Relative Love of Variety, Non-CES Utility Function

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