

**SAVING EUROPE?
SOME UNPLEASANT SUPPLY-SIDE ARITHMETICS OF FISCAL AUSTERITY**

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Abstract

In this paper we study the external effects of national tax reforms in countries with a high degree of economic integration (the eurozone). We propose a two-country model in which the home country is intended to represent the “periphery countries” (Greece, Ireland, Italy, Portugal and Spain) and the foreign country represents France, Germany and the Netherlands. The starting point is a once-and-for-all unanticipated fiscal shock, equivalent to the observed increase in the average public debt-GDP ratio of the GIIPS region between 2008 and 2011, which measured about 36 percentage points of GDP. We study alternative policy changes that can increase the net present discounted value of the GIIPS primary fiscal balance, discounted at equilibrium public debt prices, by 36 percentage points. We examine three questions. First, assuming government outlays are unchanged, what responses of taxes on factor incomes and consumption in the GIIPS group are required in order to restore fiscal solvency? Second, what are the global externalities resulting from tax policies that can restore solvency in response to large fiscal shocks? Third, if national tax authorities recognize the externalities and engage in strategic interaction, what will be the tax structures we can expect as a result of one-shot Nash tax competition in response to the fiscal shock, and how do they differ from the ones that would be obtained instead if the two groups of countries respond cooperatively to the fiscal shock. And finally, how do the answers to the above questions change if we introduce haircuts that partially redistribute the effect of the fiscal shock across the two country groups?