Box 4.6. **Special features of consumption taxes**

Beyond their potential distortive effects on domestic product and labour markets, taxes may impinge on international competitiveness. And in most countries, there are fears that non-competitive tax systems induce physical and human capital to move abroad. From this perspective, consumption taxes are often viewed as a better option than social security contributions or personal income taxes that directly weigh on households' incomes. Along this line, Germany has recently reduced contributions for the unemployment insurance by 2 percentage points (from 6.5 to 4.2) while at the same time increasing the standard consumption rate from 16 to 19%. Although this substantial hike pursues broader policy objectives of budget consolidation than solely reducing direct labour taxation, one third of the corresponding additional revenues is expected to finance the cut in unemployment insurance contributions.

As consumption taxes are levied on imported goods but not on exported goods (while the opposite is true for social security contributions), such a tax shift may raise competitiveness if labour costs decrease as a result and domestic producers cut their sales prices by the amount of the cost relief. This gain of competitiveness may boost growth and employment, at least temporarily. However, a standard prediction of the international trade literature is that consumption taxes do not impact on either exports or imports – except in the very short-run – insofar as real exchange rate adjustments tend to offset the effect of consumption taxes on the relative prices of domestic and foreign goods. And from an empirical point of view, consumption taxes do not appear to influence trade performance in international comparisons (Desai and Hines, 2002; and Keen and Syed, 2006). Yet, in the context of a monetary union such as the euro area, raising consumption taxes in an individual country may still boost the competitiveness of the country in question *vis-à-vis* its partners. But the other member countries are likely to view such a measure as highly non-co-operative.

Moreover, (after-tax) domestic consumer prices are likely to increase as a result of a hike in consumption taxes, which in turn would deter domestic consumption and generate upward wage pressure, thus reducing the potential beneficial effect on employment. Statutory or contractual minimum-wage levels, as well as some government transfers such as social assistance, might be progressively adjusted in line with prices in order to maintain their purchasing power, even if there is no direct institutional link between social assistance or minimum-wage levels and price developments. In turn, this would both reinforce general wage pressure and raise public expenditures (as a result of increased transfer incomes per beneficiary and possibly wage increases in the public sector).

Finally, and although general redistributive issues go beyond the scope of this chapter, it is important to keep in mind that the choice between income or consumption taxes is also determined by societal preferences. Income and consumption taxes contribute to shape the redistributive pattern of any tax/benefit system, but in opposite directions: consumption taxes tend to weigh less heavily on the richest while personal income taxes redistribute income towards the poorest (see Förster and Pearson, 2002; and Immervoll *et al.*, 2005).

Some empirical evidence. Available evaluations of the labour market effects of budget neutral reshuffling of labour taxation are mainly based on simulation models. The main advantages of macro-econometric or CGE models is that they allow for a general equilibrium treatment of tax reforms. That said, evaluation results are very sensitive to the underlying assumptions, notably as regards the modelling of the wage-formation process, the extent to which benefits are indexed on consumer prices and wages, and the international openness

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