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Introduction

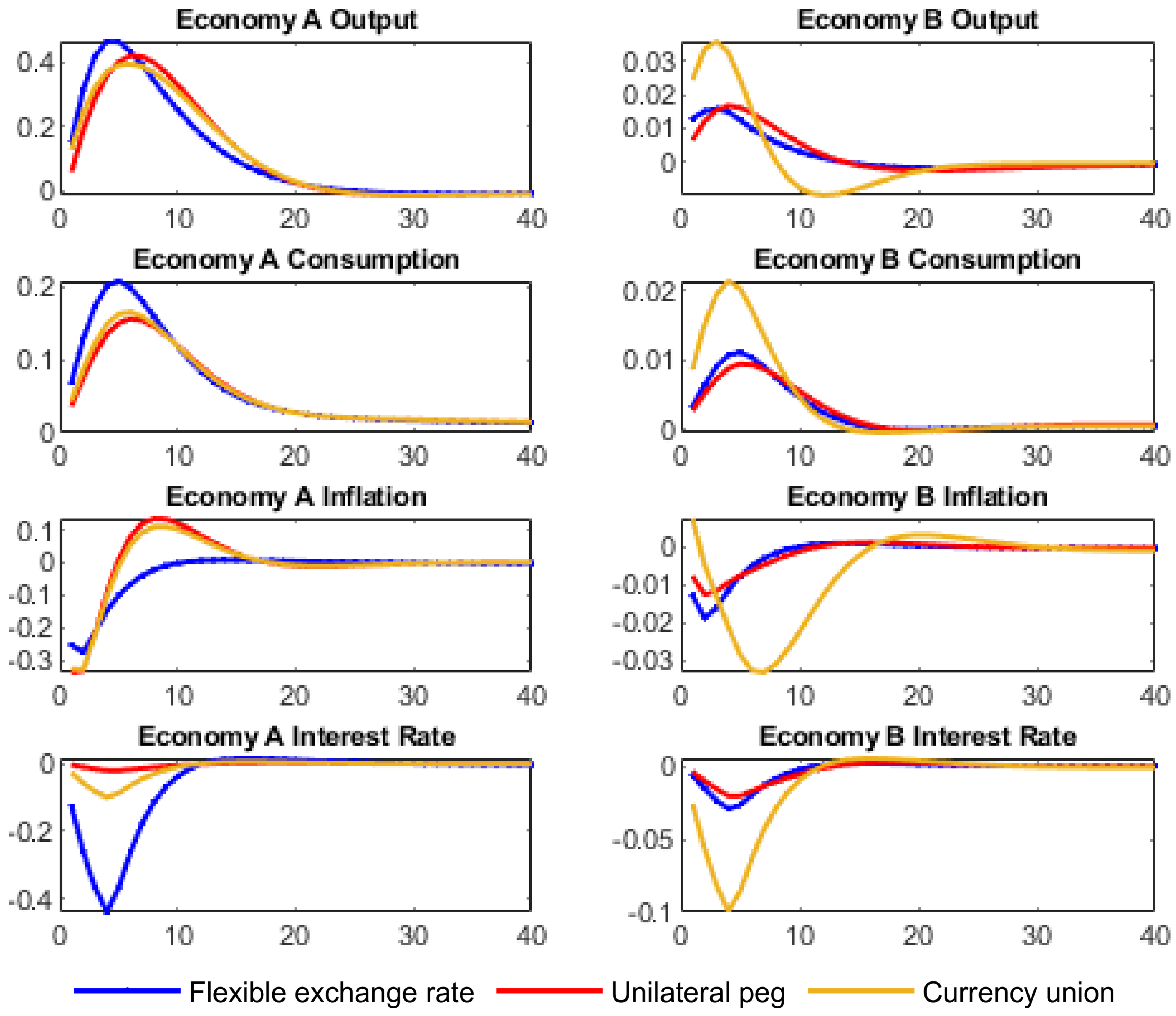
We assess the effectiveness of a cut in employers' social security contributions rate (SSCR) to stimulate economic activity under different exchange rate regimes: 1) flexible exchange rates; 2) unilateral peg; 3) currency union. We develop a three-region DSGE model and countercheck our theoretical findings empirically by applying the local projection method. We also investigate the effectiveness of a cut in the SSCR once it is counterbalanced by a raise in the consumption tax rate to keep the long-run debt-to-GDP ratio constant.

Data and methods

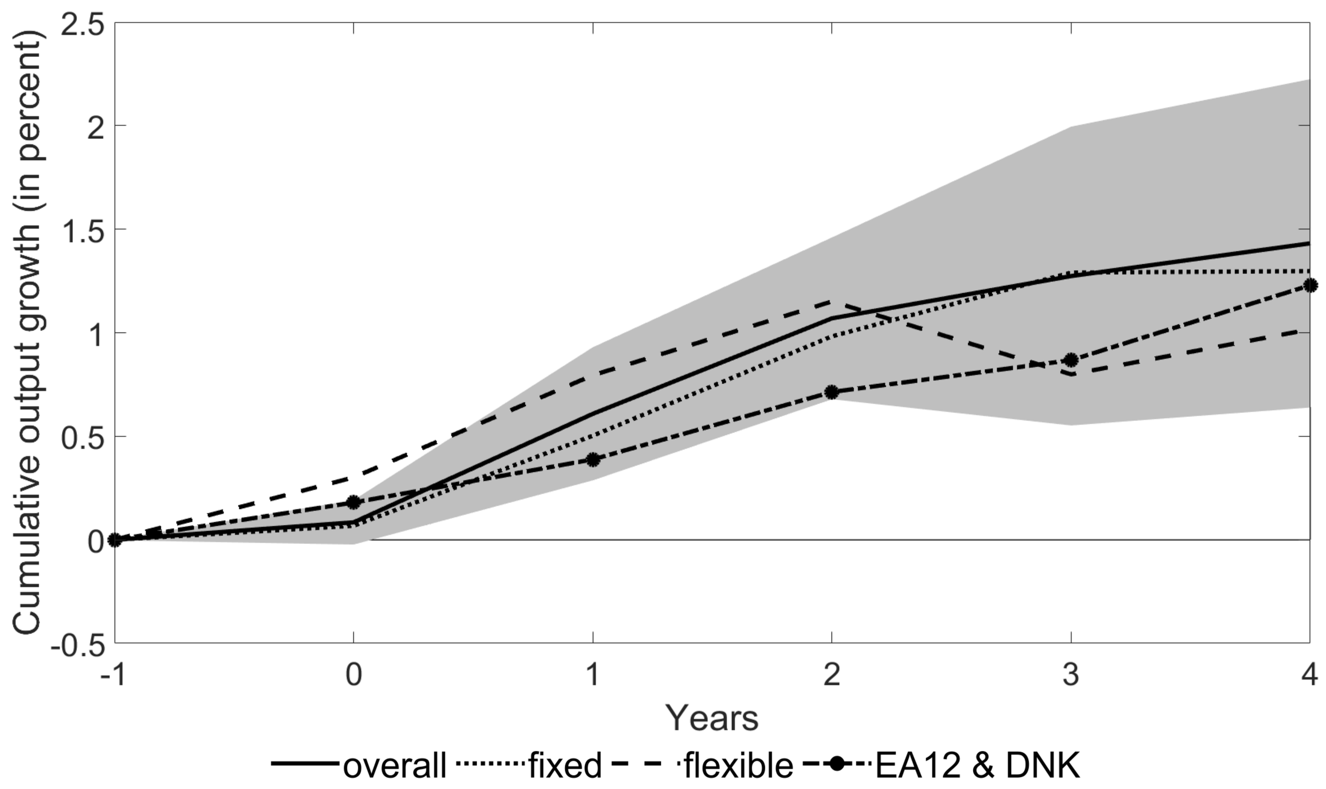
We depart from Galí and Monacelli (2005) and apply a DSGE framework built on the New Area-Wide model (Coenen et al., 2008) to assess the dynamics under different exchange rate regimes. In our regression framework we use the local projection method from Jordà (2005). Our dataset covers a balanced sample of 36 OECD economies between the years 2000 and 2019 and use data from the OECD Taxing Wages reports, the IMF World Economic Outlook Data Base and the Annual Report on Exchange Arrangements and Exchange Restriction Data Base (AREAER) by the IMF.

Results

Impulse response functions to a temporary one percent negative SSCR shock



Empirical IRFs of the cumulative output growth to a one percent reduction in the SSCR



Conclusions

The effect of a cut in the SSCR does not depend significantly on the exchange rate regime. The endogenous monetary policy channel in the flexible case amplifies the initial impact, yet the nominal appreciation that follows offsets it. A SSCR cut is still effective even if it is counterbalanced by a consumption tax raise to safeguard fiscal sustainability.

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