Port Econ J (2002) 1: 205–236

Portuguese Economic Journal

On the impact of a tax shock in Portugal*

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Received: July 2001 / Accepted: March 2002

Abstract. In 1999, Cavaco Silva, the Portuguese Prime Minister from 1985 to 1995, proposed a comprehensive tax reform package, which is to this day the basic reference in the tax policy debate in Portugal. A tax shock would consist of 4pp cuts in the corporate income tax and in the firms' social security contribution rates, and a 5pp reduction in the highest personal income tax rate. These cuts would be financed by combating tax evasion, curbing wasteful public expenditure and, if necessary, by increasing the VAT rate by up to 2pp. Using a dynamic general equilibrium model to evaluate the effects of this tax shock, we find that the long-term GDP gains would be between 0.72% and 2.91% while the effects on lifetime private welfare would range between –0.99% and 0.9%. The efficiency of this tax reform package depends critically on the way the tax cuts are financed to ensure deficit neutrality. Because investment is subject to adjustment costs, to alleviate the long-run trade-off between GDP and welfare, tax policy changes must induce a significant increase in net labor income.

Key words: Efficient tax reform – Portugal – Dynamic general equilibrium

JEL Classification: C68, D58, E62, H21, H30

*A previous version of this paper was presented at the Society of Computational Economics and SPiE conferences. Thanks are due to Fernando Chau, Emanuel Santos, and two anonymous referees for very insightful comments and suggestions. The views in this article are of the authors alone and do not reflect the position of the Portuguese Ministry of Finance.

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