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Fiscal Devaluation Practice in Turkey: The Period of 1985–2016

1 Introduction

Along with globalization, economies implement external, internal and fiscal devaluation options to increase their competitiveness. These options aim to improve net exports and thus promote economic growth. External devaluation refers to the depreciation of the real value of the exchange rate externally (by central banks) in economies within a fixed exchange rate system. The decline in the real exchange rate leads to a decrease in the domestic demand and an increase in foreign demand (exports) by lowering the price of the exported goods and by increasing the prices of imported goods, thus deepens the current account deficit. The alternative policy option for the economies without the fixed exchange rate system is an internal devaluation. An internal devaluation is a policy option that aims to ameliorate the current account deficit by minimizing production costs, primarily unit labor costs. Therefore, this option stems from the notion that by decreasing wages of both public and private sector employees, the domestic aggregate demand would be reduced and thus imports would be hampered since political decision-makers cannot inflict a direct impact on the general price level. The third policy option is the fiscal devaluation which constitutes the main subject of the study. Besides reducing labor costs directly through fiscal devaluation, it is also aimed to reinforce the competitiveness and economic growth by modifying tax composition (Ruprah, 2013: 4–10). This devaluation option is currently in dispute as an alternative fiscal policy option for the EU member states which cannot implement independent monetary policies.

In this study, the definition and scope of fiscal devaluation are discussed. In the second part, the transmission mechanism of fiscal devaluation is considered, and a mechanism proposal is developed by us. In this study, quantitative analyses based on country examples are performed. Consequently, the study is finalized featuring the VAR analysis evaluation of the fiscal devaluation for applicability in Turkey and a conclusion part.

2 Fiscal Devaluation Concept

Currently, most of the European Union (EU) member states are experiencing economic and/or social crises and are struggling against slow growth and increasing unemployment, being unable to implement monetary policies due to the constraints of high public and external debt (Eiras, 2013: 1). In this respect, the disadvantages of the monetary union adopted by the EU member states, especially with the crisis

Tab. 1: Standard and Alternative Fiscal Devaluation Types

<i>Standard Fiscal Devaluation</i>	
Decreasing employers' share in social security contribution	The increase in VAT
<i>Alternative Fiscal Devaluation</i>	
Decreasing employers' share in social security contribution	-The decrease in VAT (Instead of the standard rate, reducing the VAT rate would also increase overall tax efficiency) -Increase in both Excise Duties and Property Taxes -The increase in Environmental Taxes -The decrease in Public Expenditure

Source: Puglisi (2014), p. 6.

of 2008, increased their impacts, and the support for the use of the Euro as the common currency unit followed a declining trend. Impossibility of monetary devaluation practices aiming to mitigate the impact of the crisis, due to the monetary union implemented in the EU, led to the introduction of fiscal devaluation to solve this problem (Bordignon et al., 2014: 2; Vdovychenko and Zubrytskyi, 2015: 23).

Throughout this process, the fiscal devaluation has been used as a fiscal policy option in order to increase the competitiveness of the EU member states. Fiscal devaluation is described as an application aiming at increasing tax rates determined in an economy while decreasing the others and thus increasing the international competitiveness of the economy by reducing production costs (Kaya, 2015: 167). Nevertheless, as of today, the concept refers to a shift from employers' social security contributions, in line with the approach of increasing competition through inter-tax substitution, towards the value-added tax (VAT) (Koske, 2013: 7; Hohberger and Kraus, 2016: 512). Therefore, with the fiscal devaluation, which happens to be a fiscal policy that does not influence the budget deficit (Bosca et al., 2012: 28), the financial obligations of the economies that would contribute to boosting the competitiveness of the economies in international markets are reduced; as a result, the fiscal budget deficit is financed by indirect taxes imposed on those who have higher consumption propensities. Real wages eventually decline by the end of this period through which nominal wages are held constant, and a significant decrease in the labor costs in export-led sectors producing goods or services.

Tab. 1 exhibits the relationship of fiscal devaluation with standard and alternative tax policies. Accordingly, a fiscal devaluation practice with tax shift would promote both employment and economic growth in the long run by raising the

efficiency of the tax system. Moreover, fiscal devaluation can be undertaken not only by imposing higher VAT rates but also by increasing the rates of excise duties and property taxes placed in Tab. 1 (such as Special Consumption Tax and Real Estate Tax). The main distinguishing feature of VAT in terms of fiscal devaluation is expressed as its direct impact on production costs (Puglisi, 2014: 5). Although raising VAT rates result in a decline in consumption and a rise in the prices of imported goods (Annicchiarico et al., 2015: 733), raising the VAT rate far beyond efficiency would result in a decrease in tax revenues. Nonetheless, to implement the fiscal devaluation, the government must reduce the labor costs incurred by employers so that the prices of the exported goods would be lowered by employers (Donal, 2012).

On the other hand, the idea that the impacts of exchange rate devaluation could be substituted by tax reforms is not new (Correia, 2011: 27). This method dates back to the era of the gold standard during which economies could not resort to monetary devaluation. J.M. Keynes rendered a significant opinion about the fundamentals of the fiscal devaluation approach by proposing uniform ad valorem tax tariff to be levied on imports in addition to the subsidy on exports which could have similar impacts of a devaluation (Farhi et al., 2012: 2; Mooij and Keen, 2012: 6). Thus, the innovation brought forth to the fiscal literature along with the concept of fiscal devaluation refers to decreasing the employers' social security contributions, increasing some taxes such as indirect taxes, thus improving competitiveness in international markets by decreasing the production cost of the employers (IMF, 2011: 37).

3 Transmission Mechanisms of Fiscal Devaluation

There are two transmission mechanisms which reinforce the price competitiveness of fiscal devaluation: (i) Firstly, the decrease in the prices of final products by reducing the gross labor costs would boost the net exports. (ii) Secondly, the burden of excise duties such as VAT would be reduced in the importing sectors, and the difference would be offset by importer sectors/consumers, and thus net exports would be boosted.

However, the fiscal space to be created by the reduction of the gross wages per employee would allow companies to invest in new technologies. Even though these impacts are considered as significant in the capital-intensive sectors, fiscal devaluation would strengthen employment growth without any additional pressure on production costs in labor-intensive sectors. On the other hand, as a result of fiscal devaluation and reduction in employers' social security contributions, informal employment would also decrease. But, despite these advantages, the fiscal devaluation practice does not constitute a reform in terms of not mitigating the structural barriers to global competition; it is considered to be a temporary solution (Milosevic and Babin, 2016: 191–192).

By courtesy of the transmission mechanism of fiscal devaluation, importing and exporting companies are assumed to have the power to affect prices by including

nominal costs in prices. In order to increase the competitiveness in international markets, political decision-makers wish to implement the fiscal devaluation option for minimizing this cost burden on employers. Accordingly, employers' social security contributions would be reduced, and the fiscal budget deficit would be compensated by increasing consumption taxes or reducing public expenditures. At this point, there would be two impacts on the market actors: The first impact involves the reduction in consumption since consumer decisions are influenced and thus savings would be increased. The second impact would occur particularly in the sectors which produce tradeable goods. Accordingly, entrepreneurs with diminishing labor costs would increase their international competitiveness in exports by reducing the prices in the upcoming period ($t+1$). In this context, the transmission mechanism can be expressed as follows:

$$\Delta SSC \downarrow \& \Delta VAT \uparrow \rightarrow \Delta \pi \uparrow \& \Delta TGP \downarrow \rightarrow \Delta (Y - Y^*) \downarrow \rightarrow \Delta CAB \downarrow \rightarrow \Delta g \uparrow$$

In the mechanism illustrated above; SSC , VAT , π , TGP , $(Y - Y^*)$, CAB , and g denote social security contributions, value-added tax, firms' profit rate, prices of tradeable goods, production gap, current account balance and growth rate; respectively. Accordingly, reducing the social security contributions in the sectors where the tradeable goods are produced along with increasing the indirect taxes would decrease the export costs of the relevant firms and ultimately increase their profits. The increase in exports would result in a decrease in the production gap by encouraging firms to produce at a potential output level, and it positively influence the current balance of payments. By the end of this process, the foreign exchange inflow would increase for the economies in which the international competitiveness is boosted by altering production costs to the disadvantage of the labor force. Nonetheless, the production growth would result in a decrease in unemployment by boosting net exports and, in turn, the economic growth rate would also increase.

4 Quantitative Analyses on the Country-Based Examples

The country-based examples of fiscal devaluation practices were first encountered in Denmark as of 1987. In Denmark, the unemployment and disability insurance tax, which is devolved on employers, is abolished; this tax is replaced with a VAT-like tax by shifting it on the consumer goods. A similar implementation was observed in Germany, which increased the VAT rate from 16 % to 19 % in 2007 and reduced the employers' social security contribution by 1.8 points. Furthermore, it was implemented in Hungary in 2009 accompanied by a 5-point decrease in the employers' social security contribution and a 5-point increase in VAT rate (Koske, 2013: 7). Similar practices have been implemented in other EU member countries such as Finland (2010), Netherlands (2012) and France (2014) over the years (Milošević and Babin, 2016: 193).

The conducted studies assert the short- and long-term *positive impacts* of fiscal devaluation on net exports expressed as economic growth, employment and foreign trade balance. Nevertheless, the findings of the studies indicate that those impacts remain at very *small rates*. For instance, Langot et al. (2011) found that the long-term impact of the fiscal devaluation on the GDP in France was 0.1, whereas no impact on net exports was detected. Engler et al. (2013) claimed that the short-term impact of fiscal devaluation on the GDP in Northern and Southern European Countries ranged between 0.9 and 1.4, whereas the impact on net exports was -0.05. For other similar analyses, Pereira et al. (2014), Puglisi (2014) and Koske (2013) would be taken into consideration.

However, the effectiveness of fiscal devaluation practices depends mainly on a variety of factors with country-based characteristics such as wage rigidities, the flexibility of labor supply, size of the economy, openness to global trade and production cost (Lipinska and von Thadden, 2012: 30). Forasmuch as the impacts of fiscal devaluation practice on the foreign trade balance basically depend on the price and demand elasticities of the exportable goods. Accordingly, fiscal devaluation decreases the relative export prices of goods and, in turn, increases net exports, whereas it can lead to an increase in imports along with the expansionary impact on domestic demand. Based on the price and demand elasticities, one of these two impacts exceeds the other and influences the trade balance either positively or negatively (Puglisi, 2014: 7–10).

5 Applicability of Fiscal Devaluation in Turkey: The VAR Analysis

Upon examining several variables, it would be possible to state whether or not the fiscal policy practices in Turkey have similar attributions of fiscal devaluation. In this context, the course of the shares of a minimum wage rise in Turkey, employer costs and indirect taxes, VAT in particular, in total tax revenues can give an idea regarding whether or not fiscal devaluation would be applicable in Turkey.

In this part, time-series data such as export revenue (tex), real labor cost index (tci), the US dollar exchange rate (tc), average inflation rate in Turkey (tinf) and average inflation rate of the EU countries (euc) obtained from Turkish Statistical Institute, Eurostat and the reports of the Ministry of Labor and Social Security over the period 1985–2016 are utilized.

Prior to performing the VAR analysis, the Augmented Dickey-Fuller (ADF) and the Phillips-Perron (PP) tests are conducted to determine stationarity (unit root) of the logged series. However, the VAR model is reliable and stable.

Upon analyzing the variables via the ADF unit root test as intercept, trend and intercept and, none in order to test a fiscal policy similar to the fiscal devaluation practice in Turkey, their 1st differences are taken since they contain unit roots at level in terms of these three indicators, and it is determined that they

Tab. 2: Unit Root (Stationarity) Tests: ADF and PP

ADF Unit Root Test				
Variables		Intercept	Trend and Intercept	None
Intex	At level	0.7654	0.8615	1.0000
Intci		0.0002	0.0019	0.8190
Intc		0.7035	0.6744	0.2923
Intinf		0.8002	0.5699	0.2515
lneuc		0.4954	0.0949	0.1030
Intex	1 st diff.	0.0006	0.0025	0.0025
Intci		0.0001	0.0031	0.0000
Intc		0.0002	0.0011	0.0000
Intinf		0.0000	0.0000	0.0000
lneuc		0.0002	0.0005	0.0000
PP Unit Root Test				
Variables		Intercept	Trend and Intercept	None
Intex	At level	0.7697	0.7693	0.9999
Intci		0.1266	0.5541	0.8332
Intc		0.6634	0.6591	0.2877
Intinf		0.8002	0.5699	0.2302
lneuc		0.5297	0.0933	0.0957
Intex	1 st diff.	0.0006	0.0025	0.0023
Intci		0.0047	0.0203	0.0003
Intc		0.0002	0.0011	0.0000
Intinf		0.0000	0.0000	0.0000
lneuc		0.0000	0.0000	0.0000

become stationary. The Augmented Dickey-Fuller (ADF) and Phillips-Perron (PP) test results are presented in Tab. 2.

In order for the VAR analysis to be performed, it is necessary to determine the lag lengths after ensuring that the series is stationary. Tab. 3 reveals the lag lengths determined by Akaike (AIC), Schwarz (SC) and Hannan-Quinn (HQ) information criteria.

According to Tab. 3, it is concluded that there is no lag length in terms of three information criteria. On the other hand, upon administering a shock to one of the variables, the results of VAR impulse-response analysis which express the

Tab. 3: Information Criteria for Determining Lag Length in VAR Model

Lags	AIC	SC	HQ
0	3.184439*	3.420180*	3.258270*
1	3.936.987	5.351.431	4.379.973
2	4.408.674	7.001.821	5.220.815

response of the other variable is shown in Fig. 1. Such an analysis is conducted to examine the dynamic relationship between the actual export figures in Turkey and the variables in the study, and thus, to determine the impact power of the variables on exports.

According to Fig. 1, in which the dashed lines illustrate the confidence interval and the straight lines illustrate the course of the impacts of the variables on exports, an inflationary shock (DLNTINF) decreases exports (DLNTEX) within the first two years, and then this impact is mitigated at the end of the five-year period in an equilibrium. In other words, export figures are adversely influenced by the impact of inflation; however, such a decrease is eliminated after five years. Similarly, the impact of an increase in real labor costs (DLNTCI) on exports is negative for the first two years; from the third year onwards, it becomes positive in an equilibrium. Accordingly, the increase in real labor cost initially decreases exports, but such an impact would cease to exist by the end of the following five-year period. On the other hand, a shock in the US dollar exchange rate (DLNTC) increases exports at a relatively small rate throughout the first three years; however, it is decreased at the end of the third year, and the impact is mitigated completely at the end of the five-year period. Consequently, due to the shock of EU inflation figures (DLNEUC), export figures tend to increase within the first two years, but then begin to decline, and the impact would be mitigated after five years.

According to the results presented in Fig. 1, it is stated that, in particular, domestic inflation rates along with the low levels of real labor costs play crucial roles in determining export revenues of Turkey.

The proportional impacts are analyzed by using the variance decomposition method. This method involves the impacts of the change in one of the independent variables on the value of the dependent variable in the current and future periods. In this context, since the impacts of the variables remain unchanged at the end of the 7th year, it is not necessary to indicate the whole period of 1985–2016, so that only the first 10-year period is considered.

The results of the variance decomposition conducted for export figures are shown in Tab. 4.

According to Tab. 4; 100 % of a 1 % increase in exports within the 1st period is explained by itself, whereas such increase is determined by itself (75.6 %), by inflation (18.6 %) and by labor costs (2 %) within the 2nd period. In addition, 74.59 % of the change in the export figures within the 3rd period is caused by the series itself,

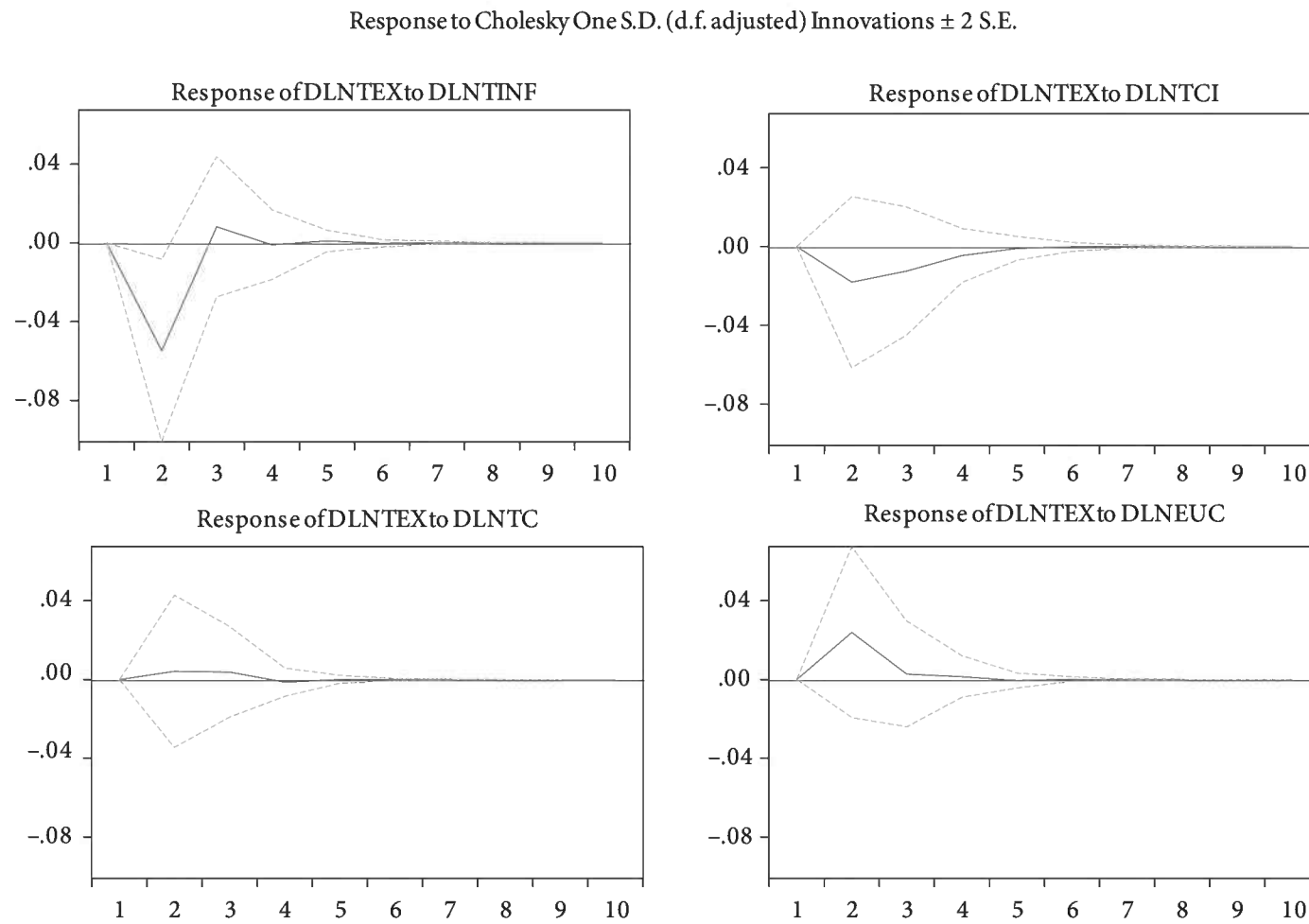


Fig. 1: VAR Impulse-Response Analysis

Tab. 4: The VAR Variance Decomposition: Exports

DLNTEX Variance Decomposition						
Period	S.E.	DLNTEX	DLNTINF	DLNTCI	DLNTC	DLNEUC
1	0.107687	100.0000	0.000000	0.000000	0.000000	0.000000
2	0.126518	75.63150	18.63597	2.047810	0.106591	3.578126
3	0.127769	74.59543	18.68810	2.967404	0.193542	3.555520
4	0.127875	74.47707	18.66256	3.092474	0.205461	3.562437
5	0.127883	74.46773	18.66567	3.097345	0.205438	3.563815
6	0.127884	74.46719	18.66590	3.097579	0.205474	3.563856
7	0.127884	74.46715	18.66593	3.097593	0.205476	3.563858
8	0.127884	74.46714	18.66593	3.097594	0.205476	3.563859
9	0.127884	74.46714	18.66593	3.097594	0.205476	3.563859
10	0.127884	74.46714	18.66593	3.097594	0.205476	3.563859

whereas 18.68 % by inflation and 2.9 % by labor costs. These impacts follow a stable trend since the 7th period.

Thus, according to the data utilized in the study and the method used in the analysis, inflation is determined as the most important variable affecting exports in Turkey. Nevertheless, it can be concluded that the export figures are influenced by labor costs by 0 %-2 %-2.9 %-3 % (constant since the 7th period), respectively. In this regard, it can be argued that fiscal devaluation similar to a fiscal policy practice is implemented.

Concisely, the impulse-response analysis exhibits the extent to which the variable reacts upon being exposed to an exogenous shock. The variance decomposition indicates at what percentages of the variation of a variable are explained by each of other variables besides itself. Table 2 illustrates whether or not this analysis has stability; in other words, it is established correctly.

6 Evaluation and Conclusion

As a result of the rising global competitiveness, economies tend to implement policies to achieve a competitive advantage in international markets. Fiscal devaluation, as one of those policies that constitute the scope of the study, refers to the use of the tax system through which production costs of employers are reduced either by shifting the difference towards indirect taxes or by reducing public expenditures. As a result of the decrease in production costs, employment and net exports are expected to increase, and economic growth is aimed at the end of this process.

This policy preference has been brought forth for the EU member countries, which are not independent in monetary policies practices and lack global competitiveness. The EU member countries which lack the option of increasing their competitiveness through monetary devaluation, usually prefer fiscal devaluation that is assumed to inflict the same impact of monetary devaluation. The econometric analyses mentioned in the study are also performed to examine these impacts which are detected to have positive, although small, contributions.

By courtesy of the VAR analysis performed, certain assessments are made which confirm the existence of fiscal devaluation practices in Turkey. Accordingly, it is concluded that the reduction of the export figures as the main indicator of global competitiveness in Turkey refers to an important factor in domestic inflation, whereas *labor cost* is of *lower* importance. This result supports the findings of the literature studies reviewed in the fourth part of the study. Moreover, certain facts such as the reduction of exports due to the rise in labor costs which, in turn, influences the variability of exports by 0 % to 3 % gives a hint about the implementation of fiscal policy regarding fiscal devaluation in Turkey.

On the other hand, it is seen that employer costs and net minimum wage tend to increase in years during which the percentage share of taxes in the budget rise. The facts such as percentage increase in employer costs, especially during times of crisis, being higher than that of the increase in net cost and the existence of subsidies, particularly the minimum subsistence allowance, *does not support* the applicability of the fiscal devaluation in Turkey. Also, Turkey is considered to be independent in terms of monetary and fiscal policy practices due to *not being an EU member*. Nonetheless, the partial dependence on monetary and fiscal policy practices along with the impact of globalization should not be attributed to *being a member of any monetary union*, but, in particular, it should be related to short-term speculative capital movements that are not intended to adversely influence investors' expectations.

On the other hand, the desired export-led competitive advantage through fiscal devaluation practice does not require the undisputed acceptance of the tax rate increases proposed by international organizations. Besides transferring public expenditures towards efficient and job-creating sectors free of populism, the fiscal space would also be revealed if public expenditures are not increased and the current spending components are regulated by a rational mechanism. Therefore, without imposing any tax increases, designing available incentive programs to increase the competitiveness of exports along with the existing financial resources is also a point worth considering.

It is generally accepted that the shift of taxation from labor force towards consumption has a positive impact on employment and that it increases growth, whereas such a policy reform can be detrimental to income distribution according to Burgert and Roeger (2014: 5). In this regard, the revenue (or wealth) created in the economy may not be included in the production through fiscal devaluation practices; instead, it may cause disruptive impacts on income distribution by means of either transfer to the financial markets or leakages. In addition, merely

the price level is considered as a problem as far as fiscal devaluation is concerned, but not the qualities and elasticities of goods produced, or the level of foreign exchange rates in terms of the rise in global competitiveness. Such an inference is similar to mercantilist (conservative) policies which support the idea that exports would be more vital than domestic demand. Furthermore, this policy choice would have a negative impact on the international division of labor through an artificial reduction in domestic demand (Christensen, 2013).

Nonetheless, this approach is thought to have an adverse impact on sectors with lower propensity to save. Due to the demand contraction in the domestic market, there would be a social imbalance and an artificial allocation of production factors. In addition to the decreasing impact of indirect taxes on domestic demand, a contraction in global demand would constrict demand even further. It is also necessary to discuss how the economies take precautions against the adverse impacts of such a situation on the fiscal structure.

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