Bringing macroeconomics back into the political economy of reform: the Lisbon Agenda and the ‘fiscal philosophy’ of EMU

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Abstract
The Lisbon Strategy supports reform of member states’ tax-benefit systems while the ‘fiscal philosophy’ of the EU postulates that governments should allow only automatic stabilisers, built into tax-benefit systems, to smooth aggregate income. We ask whether these two pillars of EU economic governance are compatible. By exploring how structural reforms affect fiscal stabilisation, we complement a political economy literature that asks whether fiscal consolidation fosters or hinders structural reforms. We conclude, based on simulations in EUROMOD, that Lisbon-type reforms may worsen the stabilising capacity of tax-benefit systems.

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Introduction

This paper asks to what extent two central pillars of economic governance in the EU are compatible. The European agenda for growth and jobs encompasses both macroeconomic stability, the Maastricht pillar, promoted by the Stability and Growth Pact (SGP) and the Broad Economic Policy Guidelines (BEPG), and microeconomic or structural adjustment, the Lisbon pillar, developed through the European Employment Strategy (EES) in particular. We begin by viewing the issue of compatibility in political economy terms, and then explore the economic aspect of this incompatibility, focusing on the ‘automatic stabilisers’. Automatic stabilisers are revenue and expenditure items of the budget that vary counter-cyclically with the income or spending of citizens and thus add to their disposable income in recessions and reduce it in booms. They are ‘automatic’ in the sense that governments do not need to enact their operation in the particular stage of the business cycle since they vary with their base by design.

The fiscal philosophy of the SGP and BEPG endorses ‘rule-based’ as opposed to discretionary macroeconomic stabilisation. Governments should rely on the automatic stabilisers to do the smoothing of aggregate income. At the same time, the structural reform agenda emphasises the desirability of increasing the flexibility of the labour market and improving incentives for job creation through lower tax rates (CEC, 2005a, p.6). This paper explores how such reforms may affect the automatic stabilisers.

The prevailing tenor of the EU’s reform agenda is that structural adjustment will also take care of macroeconomic stabilisation. The Integrated Guidelines for Growth and Jobs (CEC, 2005b, p.15) argue that failure to pursue structural reforms will undermine macroeconomic stability. Furthermore, market reforms are seen as ‘improv[ing] the overall adaptability and adjustment capacity of economies in response to changes in cyclical economic conditions’ (ibid; our emphasis). In other words, appropriate microeconomic policies will obviate the need for macroeconomic stabilisation. In fact, a weakening of automatic stabilisers may be a blessing in disguise as less stabilisation would improve the private sector’s own capacity to adjust and self-insure (Buti et al, 2002; Buti and van den Noord, 2003). We address this argument both theoretically and empirically.

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1 See, for instance, Barrell and Pina (2000, p.1) and Buti et al (2003, p.28) on the underlying philosophy of the Pact: the deficit ceiling over the cycle must be chosen so as to allow for the operation of automatic stabilisers within the cycle.
Our paper proceeds as follows: First, we outline in section I how our study relates to wider debates in the political economy literature. Section II will describe the conceptual framework. Our empirical analysis in section III tries to establish, first, whether there is any evidence for reforms taking place to an extent that could affect the macroeconomy; secondly, how reforms would affect automatic stabilisers based on simulations in EUROMOD, a tax-benefit model of the EU-15 countries; and, thirdly, whether our results suggest a tradeoff between stabilisation and adjustment. The conclusions sum up by outlining policy implications.

I. The conflicting political economy of the EU’s simultaneous agenda

The relevant political economy literature on the links between structural reforms and fiscal policy can be divided in two strands. The first starts from the diagnosis of pervasive time inconsistency in policymaking and argues in favour of fiscal consolidation being done simultaneously with structural reform, as is currently promoted by the SGP/BEPG and the Lisbon Agenda. The second strand, based on the comparative study of major reform processes, calls for sequential timing of reforms and budget consolidation, suggesting that the Lisbon Agenda may otherwise suffer a double whammy from fiscal austerity. Not only will reforms be more unpopular in austere conditions, but also governments may be drawn towards perverse reforms which shift costs onto firms in order to avoid budgetary obligations. We side in principle with the latter strand but add that structural reform under conditions of permanent fiscal austerity may also jeopardize the stabilising qualities of fiscal systems, despite a potential to enhance them.

The ‘back against the wall’ rationale for the EU’s simultaneous agenda

The first strand maintains that the simultaneous agenda of the EU promises a double dividend of fiscal prudence and reform activism (Bean, 1998; Padoan and Rodrigues, 2004). More specifically, the hardening of governments’ budget constraints has the potential to provide the political room for manoeuvre to proceed with labour market reforms. Because public expenditures are constrained by a fiscal rule such as the Stability Pact, the labour market parties (unions in particular) eventually realise that regulations and wage settlements have an immediate impact on employment that will be borne by private sector employers or union members. This ‘back against the wall’ hypothesis maintains that fiscal crises make reform easier because they raise awareness of the costs of the status quo and thus weaken the opposition to reform (Rodrik, 1996, pp.26-29; IMF, 2004a, pp.113-115). In more formal terms, an unconstrained government is assumed to choose time-inconsistent, inflationary policies. Once prevented from doing so by monetary and fiscal rules, its incentives change in favour of promoting labour market reform to lower the equilibrium unemployment rate.
The most explicit argument along these lines can be found in Calmfors (2001, pp.268-270). In his model, the government weighs up inflation, unemployment and labour market reforms, all of which are disliked by the majority in the electorate, who are also the dominant group in the labour market. Reforms can reduce equilibrium unemployment, but they are undertaken only if the benefits in lower expected inflation and unemployment outweigh the costs in terms of lower real wages or less employment security enjoyed by those in employment. In this model, the loss of access to countercyclical monetary and fiscal policies increases the incentive to reform. This assumes that labour market flexibility can dampen cycles induced by both supply shocks and inflation shocks, a view we question below. It is also assumed that more reform and less countercyclical demand-management is socially desirable, because such a move would raise the welfare of labour market outsiders, who are the political minority.

The endorsement of automatic stabilisation within ‘back against the wall’ models is half-hearted at best. It is endorsed as a form of rule-based policymaking but questioned as potentially slowing down adjustment to shocks. All policymaking is seen as distortionary, except if it consists of attempts to correct structural market imperfections that can reduce the longterm equilibrium of unemployment. Given their preferences, governments need to be whipped into such enlightened reform policies. Externally enforced fiscal consolidation may provide for such a whip and thus yields a double dividend of structural flexibilisation and fiscal prudence.

The ‘need for bribes’ rationale for sequencing the EU’s dual agenda

The second strand of the political economy literature sees tensions between an ambitious agenda of structural reform and fiscal consolidation. It is based on what might be called a ‘need for bribes’ hypothesis, suggesting that fiscal space is required so as to allow compensation of potential or actual losers from reforms. Testing for these alternative hypotheses, the IMF sides with the ‘need for bribes’ hypothesis and recommends accepting a temporary worsening of public finances to make reforms happen (IMF 2004a, pp.115-116, 132; IMF 2004b, pp.48, 58). A rise in the budget deficit at the beginning may be necessary not only to buy off opposition but also in order to bear the upfront costs of reforms such as implementing more effective employment agencies in preparation for welfare-to-work measures.

This strand of the literature is interested in what determines reform dynamics, stimulated by the wealth of experience with major reform processes in countries at all levels of political and economic development (Rodrik, 1996). Partly for reasons of econometric methodology, policymaking is conceptualised as the outcome of a government optimising an objective function that is representative of an electoral platform or of the median

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voter’s preferences. But the government is also constrained by economic and political factors that are not directly under its control (IMF, 2004a, p.109). Without these constraints that determine whether structural reforms get sufficient political support to be carried out, a government would steadily implement the measures that make the political economy move on the reform path towards the desired state of labour, product and financial markets or the tax system.\(^3\)

One important argument in favour of the ‘need for bribes’ is that structural reforms under conditions of ‘permanent austerity’ (Pierson 2001) are biased towards measures which are fiscally favourable and shift costs to firms. In particular, stricter employment protection may be conceded in exchange for lower non-employment benefits. Such perverse reforms are a product of reform activism under fiscal constraints. The Lisbon Agenda may thus get a double whammy from simultaneous fiscal consolidation and welfare reform: not only does austerity weaken the political support for reforms but it also gives governments incentives to engage in forms of compensation that obstruct specific Lisbon goals.

To sum up: The literature implies two stark hypotheses on the simultaneous agenda of the EU. The first strand argues that combining fiscal consolidation with structural reforms yields a double dividend, providing both for healthier public finances and signalling to entrenched interests that the status quo has become too expensive and will be changed. The second strand argues that the dual agenda of the EU will obstruct reforms because simultaneous fiscal consolidation and reform is likely to weaken political support and create counterproductive incentives for governments. Neither strand problematises the relationship between fiscal stabilisation and consolidation. The ‘need for bribes’ hypothesis, stressing the need for fiscal flexibility, is more consistent with automatic stabilisation. Consolidation should not be pursued in a procyclical way because that creates even more discontent. However, the current European fiscal policy framework is oriented towards a ‘back against the wall’ logic in which recessions are assumed to improve the political conditions for reform.

**Bringing macroeconomics back into the political economy of reform**

Our study builds on the ‘need for bribes’ hypothesis by scrutinizing the macroeconomic effects of reforms. If the Lisbon Agenda is bad economics in the sense that it weakens fiscal stabilisers, then it is also bad politics. More micro insecurity, not compensated by more macro stability, potentially furthers a backlash against European integration. We examine how ‘Lisbon-type reforms’, meant to increase the incentives for seeking

\(^3\) Econometrically, this means that a dynamic equation links the annual changes in structural reform indicators to their past levels (ie. taking account of initial conditions and path dependency), to a set of explanatory variables that presumably constrain a policymaker’s reform decision (the economic and political constraints identified by the literature on the political economy of reform) and to a stochastic term that captures uncertainty (IMF, 2004a, Appendix 3.2).

We concur with these authors that automatic stabilisers can solve a number of problems, among them preventing the procyclical handing out of bribes or the failure to consolidate in good times, both inherent in the political exchange that characterises reform processes in mature welfare states. Reliance on symmetrically operating stabilisers may thus create the fiscal space for manoeuvre, for instance to bear the upfront costs of reform. However, we do not treat welfare reforms as synonymous with fiscal consolidation since the Lisbon Agenda also calls for lower taxes which does not help consolidation. Moreover, our research question requires us to broaden the notion of ‘effective’ fiscal policy in the political economy literature. ‘Effectiveness’ entails the sustainability of public finances, now the sole focus of fiscal policy coordination in the EU, as a necessary but not sufficient condition for stabilisation and efficient public goods provision. A budget, while supremely prudent and sustainable, can be too small to provide for effective stabilisation.

There are a number of factors that make the stabilisers more or less effective which governments are about to change by Lisbon-type reforms. For instance, the stabilisers are more effective the more they are targeted at the lowest income deciles because low-income households are typically credit-constrained so that their consumption depends on their disposable current income. These are precisely the households who are also targeted by the Lisbon Agenda, be it through tax cuts or benefit reforms in order to enhance work incentives. Income, employment and spending patterns of these households may therefore change. Thus, structural reforms have macroeconomic spillovers, affecting the need for stabilisation as well as the capacity of tax-benefit systems to stabilise.

Our attempt to bring macroeconomics back in implies a different emphasis in political economy terms. Automatic stabilisers incorporate tax and social security commitments, but to the extent that governments embrace the Lisbon Agenda these commitments are subject to change: much of the welfare reform/ labour market flexibilisation agenda advocates reneging on some of these commitments. Entitlements to a defined amount of

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4 Directorate General (2005, pp.33-37) reviews the literature on the ‘macroeconomic impact of some packages of Lisbon reforms’, yet all that this survey provides are various estimates of the aggregate gains in GDP growth to be expected from microeconomic reforms in product and labour markets or investment in the ‘knowledge economy’.

5 We are grateful to Elena Bechberger (LSE) for alerting us to this paradox. Her thesis will explore welfare state reforms from this angle in France and Germany.
unemployment benefits or pensions are called into question. Reforms, in particular in 
contribution-based welfare systems, might thus amount to a publicly endorsed breaking 
of commitments which has the potential to affect households’ confidence in collective 
insurance.\(^6\)

This political macroeconomy perspective indicates just how challenging the simultaneous 
agenda of the EU is for governments. They are not only asked to disappoint the 
confidence of their electorate in that successful welfare state reforms will break earlier 
commitments, but the same reforms may also make fiscal stabilisation less effective. This 
hardly gives the impression of effective government bolstered by the benign force of 
European integration. Yet, if Lisbon reforms not only modernise EU welfare states but 
also make fiscal stabilisation more effective, government and the EU may be legitimised. 
Thus, it seems to us that the political economy of reform in the EU should turn the 
traditional question around and ask not how fiscal consolidation affects structural reform 
but how structural reforms may affect the conduct of fiscal policy for macroeconomic 
stabilisation.

II. How structural reforms affect automatic stabilisers

*What determines the size of automatic stabilisers?*

Even in less generous welfare states like the U.S., a large part of household income 
smoothing is done by the stabilisers built into tax and transfer systems (Asdrubali et al, 
1996). The size of an automatic stabiliser such as the personal income tax or 
unemployment benefits is the result of two components:

*Responsiveness:* A stabiliser must vary with the business cycle so as to trigger a counter-
cyclical response. Those on the revenue side should be positively correlated with income 
changes (fall when income falls, rise when income rises) and those on the expenditure 
side should be correlated negatively (fall when income rises, rise when income falls). 
This responsiveness or cyclical sensitivity is measured by the elasticity of the particular 
budget item, for instance the percentage change of tax revenue induced by a 1 per cent 
change of income. A progressive tax structure, whereby tax revenues vary more than 
proportionally with the change in the underlying base (elasticity larger than 1), increases 
the countercyclical responsiveness of automatic stabilisers (Auerbach and Feenberg, 
2000, pp.14-17; van den Noord, 2000, pp.7, 16). The withdrawal of benefits as income 
increases also raises responsiveness, thus high effective marginal tax rates are good for 
stabilisation although they may be bad for work incentives.

\(^6\) Compare the recent comments of the governor of the Bank of Finland that the weakness of the Eurozone 
is baffling: “Perhaps reforms first increase uncertainty.” (Financial Times, 2005)
Weight: Obviously, the ability of a budget item to smooth aggregate private demand increases with the quantitative impact it has on personal income, be it via an high tax or via a large benefit. If the focus is on household market income, the weight of a stabiliser is measured as its share in income. The share of taxes or transfers varies widely across different household income groups; this may be significant in determining their role in stabilising consumption. Smoothing the income of individuals with a high propensity to spend or households that are credit constrained will make stabilisation more effective as more of the income smoothing translates into consumption smoothing. Moreover, low incomes also tend to be more volatile, so there is more to stabilise to begin with (Auerbach and Feenberg, 2000, p.12). Thus, transfers and tax credits or exemptions that directly target low income earners will have a stronger stabilising effect.7

Which elements of the EES are likely to have an impact?

As mentioned in the introduction, we focus on the European Employment Strategy (EES) as a core element of the Lisbon Strategy. The ‘Lisbon-type’ reforms (Directorate General, 2005) that our empirical study covers are contained in member states’ National Action Plans (NAPs) on Employment for 2004; the Appendix lists the relevant measures in more detail.

- One imperative is to make fiscal revenue systems more ‘employment friendly’: The measures entail (a) reducing taxes and social insurance contributions for workers or companies; and (b) lowering effective marginal tax rates, often targeted at low-income or secondary earners, by flatter tax rates and/or by increasing tax credits for earned income. Obviously, these measures affect the size of government and the progressivity of financing the welfare state; both the weight and responsiveness of the stabilisers are likely to fall.9
- Another recurrent theme, relevant to our study, is the declared intention to make benefit systems more ‘activating’ for the inactive, the precariously employed and the unemployed: The measures comprise above all elements of retrenchment, such as to lower replacement rates, to shorten benefit duration and to condition benefits on having a job or entering a training programme; they also entail increases in the minimum wage or the introduction of targeted tax credits. These measures are likely to have countervailing effects on the weight and cyclical sensitivity of the benefit system. Benefit expenditure may become more cyclically sensitive, but the share of benefits in income (weight) will fall.

7 Auerbach and Feenberg (2000, pp.13-14) estimate, however, that a large share of automatic stabilisation benefits richer households where the multiplier effect is minimal.
8 Auerbach and Feenberg (2000, pp.13-14) estimate, however, that a large share of automatic stabilisation benefits richer households where the multiplier effect is minimal.
9 The European Economic Advisory Group (2003, p.50) also expects that reforms directly or indirectly contributing to fiscal consolidation weaken automatic stabilisers.
Finally, many NAPs announce measures to flexibilise employment contracts. The measures that governments envisage under this heading are not of immediate consequence to public finances but are supposed to reduce employment protection and to facilitate part-time work, in particular for women. These measures are likely to affect the need for stabilisation in a complex way. There may be higher turnover in the labour market, exposing households to more risk. At the same time, households’ ability to manage risk may increase if their income sources are more diversified, due to higher participation rates and a wider range of labour market opportunities.

We would like to stress that we do not take a view on whether these three reform imperatives as formulated are desirable or not. But we think they are a fair representation of what the Lisbon Agenda calls for while this regrouping makes them more manageable for empirical study.

*Can microeconomic flexibility substitute for macroeconomic stabilisers?*

A recent debate on the role of labour supply in automatic stabilisation allows us to contrast our line of reasoning with one prioritizing microeconomic flexibility. Buti and van den Noord (2003) argue that automatic stabilisation of demand may easily become counterproductive because those features that make stabilisers effective also create disincentives for labour supply. This hypothesis implies that countries with more effective stabilisers should have higher unemployment and less volatile employment, less volatility here being interpreted as less flexibility. Our theoretical objection to these propositions is that Buti and van den Noord’s argument is really about structural adjustment, extended in an *ad hoc* way to encompass cyclical phenomena.

Progressive taxes or a large tax burden drive a wedge between producer wages and take-home pay. Whereas the standard argument about tax wedges is that they reduce the structural or equilibrium level of employment, Buti and van den Noord (2003) claim that automatic stabilisers will make short run aggregate supply less responsive to cyclical fluctuations. Short-run supply elasticity is taken to be desirable in enabling households to adjust to supply shocks. There are two problems with this argument. First, it is not clear why progressive taxes should make supply necessarily less responsive to market signals (van der Ploeg, 2004). The proposition rests on the assumption that cyclical variations in the tax burden are fully resisted by wage bargainers and passed on to employers. There is scant evidence for this, as the authors themselves acknowledge. Secondly, some short-term inertia may be efficiency-enhancing. Benefits provide a transitory income that enables individuals to find the best match for their skills or take rewarding risks that they would not without this social insurance (Sinn 1995).

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10 See for a more benign view of demand stabilisation and labour supply responses Auerbach and Feenberg (2000).
Buti and van den Noord’s argument relates to an intuition which has coloured understandings of the effects of the Lisbon process, which is that an economy with improved microeconomic flexibility will experience less persistent macroeconomic shocks, so that micro adjustment can be a substitute for macroeconomic stabilisation (CEC, 2005b). A key problem with this intuition is not only what it assumes about the labour market, namely that involuntary and persistent unemployment arises from equilibria caused by imperfect competition, but also its assumption of completeness of other markets. Complete credit and insurance markets would enable all households to maintain stable consumption in the face of income fluctuations. The incompleteness of these markets gives automatic stabilisers their importance.

III. Empirical analysis: The potential impact of Lisbon reforms on stabilisation

In this section, we try to provide evidence for what may appear as a pure thought experiment: what would happen to stabilisation if Lisbon-type reforms, in particular the EES, were implemented? We ask, first, whether there is any evidence of these reforms at all happening and whether any pattern relevant to our study emerges. Then we use EUROMOD to estimate the effects of stylized Lisbon reforms on the stabilising capacity of tax-benefit systems in EU-14. Finally, we look at empirical evidence for the hypothesis that weaker automatic stabilisers may be a blessing in disguise because that improves the microeconomic adjustment capacity of member states.

Is there evidence of Lisbon-type reforms that might affect stabilisation?

The EU embarked on the Single Market Programme and the Maastricht strategy to the monetary union in the late 1980s and early 1990s, respectively. It was later followed up by the Amsterdam Treaty in 1997 that officially launched the reform agenda which is the focus of this paper. Our empirical analysis of reform activism thus distinguishes between two periods, 1987-1994 and 1995-2002, which is also dictated by the availability of data.

Table 1 provides some evidence for the reform activism of member states, using the social reforms database of the Fondazione Rodolfo Debenedetti. This database documents reforms in employment protection legislation and non-employment benefits in the EU-14 countries, starting in 1987 up to 2002.11 The table synthesizes this information in an admittedly crude way. The direction of reforms is indicated by positive and negative values, ie. they are assigned a plus if the database classifies them as ‘increasing flexibility’ (making systems less protective or generous), and, vice versa, a minus if

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11 We leave out pension reforms.-- Other documentation can be found in Fondazione Rodolfo Debenedetti (2001) for reforms until 1998, in Carone and Salomäki (2001) for the second half of the 1990s and in IMF (2004a) but only in a highly aggregated form.
reforms are classified as ‘decreasing flexibility’ (making them more protective or generous). The intensity is measured by assigning a value of ±1 to ‘marginal’ and ±2 to ‘structural’ reform measures. Reform packages containing a series of measures get an intensity value of 2 if they contain two or more marginal measures and an additional 2 for including a structural measure (so ±4 is the maximum for the intensity of any one reform package, ±2 if it contains only marginal measures).

Table 1: Welfare state reform direction\(^a\) and intensity\(^b\), 1986-1994 and 1995-2002

<table>
<thead>
<tr>
<th></th>
<th>Employment protection legislation</th>
<th>Non-employment/unemployment benefits</th>
<th>Number of reforms(^c) that decrease (-) or increase (+) flexibility of systems</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>-1</td>
<td>+3</td>
<td>0(^d)</td>
</tr>
<tr>
<td>Belgium</td>
<td>+1</td>
<td>+2</td>
<td>+4</td>
</tr>
<tr>
<td>Denmark</td>
<td>0(^d)</td>
<td>+1</td>
<td>+4</td>
</tr>
<tr>
<td>Finland</td>
<td>+2</td>
<td>+3</td>
<td>+2</td>
</tr>
<tr>
<td>France</td>
<td>-5</td>
<td>-6</td>
<td>+2</td>
</tr>
<tr>
<td>Germany</td>
<td>-1</td>
<td>+3</td>
<td>-1</td>
</tr>
<tr>
<td>Greece</td>
<td>+2</td>
<td>+4</td>
<td>-2</td>
</tr>
<tr>
<td>Ireland</td>
<td>-1</td>
<td>-5</td>
<td>+6</td>
</tr>
<tr>
<td>Italy</td>
<td>+1</td>
<td>+8</td>
<td>0(^d)</td>
</tr>
<tr>
<td>Netherlands</td>
<td>+1</td>
<td>+5</td>
<td>+1</td>
</tr>
<tr>
<td>Portugal</td>
<td>+2</td>
<td>-2</td>
<td>-2</td>
</tr>
<tr>
<td>Spain</td>
<td>+1</td>
<td>-2</td>
<td>+4</td>
</tr>
<tr>
<td>Sweden</td>
<td>+1</td>
<td>+3</td>
<td>+3</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>0(^d)</td>
<td>-6</td>
<td>+5</td>
</tr>
<tr>
<td>Number of reforms(^c)</td>
<td>15 (-); 16 (+)</td>
<td>39 (-); 41 (+)</td>
<td>15 (-); 31 (+)</td>
</tr>
</tbody>
</table>

\(\text{a}\) - for reducing, + for increasing the flexibility of the system or rewards from the labour market, according to the Fondazione RDB database.

\(\text{b}\) ±1 for ‘marginal’ reforms, ±2 for ‘structural’ reform measures; one reform package can contain several (marginal) measures thus valued.

\(\text{c}\) Number of (more or less flexibilising) reforms irrespective of intensity; the net value of a reform package containing countervailing measures determines classification as – or +.

\(\text{d}\) The zero value signifies countervailing reforms, not the absence of reforms.


The main result is that member countries have become considerably more active in the second period (compare columns 5 and 6) as well as more inclined to reduce benefits for people out of work and increase incentives to work (compare columns 3 and 4). The
country entries capture the fact that reforms are largely incremental, and they sometimes point in opposite directions: countervailing reforms are indicated where there are discrepancies between low net figures in the first four columns despite a high number of reforms in the last two columns (France, Portugal and Spain in the second period provide stark examples). Restructuring rather than retrenchment across the board seems to be the result (Rhodes and Ferrera 2000). The results are also compatible with the findings of the IMF (2004a) study according to which governments are somewhat less forthcoming as regards reforms of employment protection – in fact some have increased rather than decreased EPL (compare the balance of pluses and minuses in the last row of columns 1 and 2). There are also some surprises, namely the UK and Ireland tightening employment protection, starting from low levels. Another surprise is Germany where a large number of (marginal) reforms in the second period tend to go exactly in a direction that the government is always accused of avoiding. It is also reassuring that these findings are compatible with what the analysis of the 2004 NAPs on Employment indicate: tax and benefit reforms, in particular of marginal taxes for low-income earners, dominate the liberalisation of employment protection legislation (see Appendix).

In sum: the record of reform is not as dismal as the midterm review of the European Commission suggests (CEC, 2005a). There has been a clear change in the thrust of admittedly gradual reforms that broadly corresponds to the thrust of the Lisbon Agenda, namely to improve work incentives as determined by the tax-benefit system.

*How is the size of automatic stabilisers likely to be affected?*

We outlined above how Lisbon reforms may affect stabilisation. For our evaluation of the impact of the reduction of benefits or of average and marginal tax rates, we use EUROMOD, a tax-benefit simulation model based on micro-data for individual households in each of the EU member states (Immervoll et al, 1999). It allows us to make comparable calculations of the effects that changes in policy parameters, such as taxes or benefits, have on household income. One limitation of EUROMOD is that the model does not allow for behavioural responses in consumption or labour supply to feed back onto household income and employment. However, this means that we can focus on the direct implications of the Lisbon reforms, without having to disentangle effects induced by the assumptions of a behavioural model (Atkinson 2002, pp.8-9; Sutherland 2005).

What are, ex ante, the effects of macroeconomically relevant reforms on the responsiveness and weight of automatic stabilisers?

- Tax reforms that nearly all member states consider to be warranted and duly announce in their NAPs, namely lowering average and marginal effective taxation

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12 According to the OECD database on employment protection legislation as regularly updated in the annual Employment Outlook, the UK and Ireland are ranked as the two European countries with the least restrictive protection regimes.
(including social insurance contributions), are bound to have a negative impact on the effectiveness of disposable income smoothing. They reduce the weight and responsiveness of the stabilisers, respectively. There is an offsetting effect on the responsiveness of automatic stabilisers if governments simultaneously introduce tax credits for low-income earners, as some have done, making automatic stabilisers more responsive to fluctuations in these low incomes. However, it is unlikely that this is noticeable in the macroeconomy, given their negligible weight.

- Reforms of the benefit system that try to shift a share of welfare transfers to in-work benefits have ex ante an ambiguous overall impact on the size as determined by the two components under scrutiny. Transfers may become cyclically more sensitive since permanent transfers such as early retirement, disability or assistance to long-term unemployed become temporary, potentially responding to the business cycle. Measures such as lowering replacement rates and shortening benefit duration tend to have opposite effects on the two components: they reduce the weight of this automatic stabiliser, yet are positive for responsiveness as they replace permanent transfers by temporary, cyclically responsive benefits. In sum, the net effect of reforms on the benefit side will largely depend on whether responsiveness or weight is the dominant determinant of the size of automatic stabilisers.

Our empirical assessment thus seeks to establish how much the size of automatic stabilisers would be affected by reforms: by changing the responsiveness, measured as the (marginal) income elasticity of the affected automatic stabiliser, and the weight which is its share in disposable household income. Finally, we try to assess the net impact of these two determinants by calculating for each member state a coefficient of cyclical stabilisation which is the ratio of changes in benefits and taxes in relation to the change in gross market income.\(^\text{13}\) Box 1 gives some background on the empirical approach.

\begin{table}[h]
\centering
\begin{tabular}{|c|}
\hline
\textbf{Box 1: Estimating the size of automatic stabilisers and their determinants} \\
The stabilisation coefficient relates household market income \(y^m\) to disposable income \(y^d\): By treating transfer payments to households (benefits) as negative taxation, we get:
\begin{align*}
(1) \quad y^d &= (1-\sigma)y^m \\
(2) \quad \sigma &= \sigma(t_p, t_s, b; y^m)
\end{align*}
\hline
\end{tabular}
\end{table}

The stabilisation coefficient \(\sigma\) incorporates ("is a function of") automatic stabilisers on the revenue side (personal income taxes \(t_p\), social insurance contributions (SIC) \(t_s\)) and transfers on the expenditure side (benefits \(b\)) that determine disposable household income. For the analysis of cyclical stabilisation, we need to estimate \(\sigma\) in the vicinity of trend or equilibrium income \(y^*\). However, a simulation model like EUROMOD examines

\(^{13}\) The following is based on Mabbett (2004).-- We are grateful to the EUROMOD research team (Immervoll et al 2004), in particular Holly Sutherland, for giving us the permission to use the results here.
changes in income, benefits and taxation relative to the model baseline (in this case, 1998), rather than being able to estimate equilibrium income. 14 The coefficient of cyclical stabilisation can be measured as

\[ (3) \quad \sigma = 1 - \frac{\Delta y^d}{\Delta y^m} \]

where \( \Delta \) signifies ‘arithmetic change’ in the respective variable.

An equivalent method for estimating \( \sigma \) is to identify the elasticity or responsiveness of taxes, SICs and benefits with respect to a change in market income, and derive \( \sigma \) as the sum of the elasticity times the share in \( y^m \) of each component:

\[ (4) \quad \sigma = \beta_p \cdot s_p + \beta_s \cdot s_s - \beta_b \cdot s_b \]

where \( \beta_i \) represents the income elasticity of each component and \( s_i \) represents the share in \( y^m \) of each component. It can easily be shown that equations (3) and (4) are equivalent formulations of the stabilisation coefficient (with \( t_p \) for income tax, \( t_s \) for employee SIC and \( b \) for benefits):

\[ (3a) \quad \sigma = \frac{\Delta y^m - \Delta y^d}{\Delta y^m} = \frac{\Delta t_p + \Delta t_s - \Delta b}{\Delta y^m} \]

\[ (4a) \quad \sigma = \left( \frac{\Delta t_p \cdot y^m}{\Delta y^m} \cdot \frac{t_p}{y^m} \right) + \left( \frac{\Delta t_s \cdot y^m}{\Delta y^m} \cdot \frac{t_s}{y^m} \right) - \left( \frac{\Delta b \cdot y^m}{\Delta y^m} \cdot \frac{b}{y^m} \right) \]

\[ = \beta_p \cdot s_p + \beta_s \cdot s_s - \beta_b \cdot s_b \]

Table 2 presents estimates of the stabilisation coefficient \( \sigma \) generated by simulating a 10% increase in earnings. The model calculates for each household the effect of higher earnings on taxes, SICs and benefit entitlement. The simulation does not include any status changes for household members (e.g. from unemployment to employment) so the effect on benefits is slight since only benefits such as working tax credits or social assistance which are related to earnings are affected.

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14 The microdata in EUROMOD are adjusted to 1998 values, but countries were not all at the same point in their economic cycles when the data were collected in the 1990s, so the deviations are not from the same cyclical position. This might affect the results if there are significant non-linearities in aggregate tax and benefit responses to changes in income.
Table 2: Estimates of responsiveness, weight and income stabilisation in EU-14

<table>
<thead>
<tr>
<th></th>
<th>Responsiveness(^a) of automatic stabilisers ((\beta_i))</th>
<th>Weight(^b) of automatic stabiliser ((s_i))</th>
<th>Stab. coefficient</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Income tax ((\beta_p))</td>
<td>Employee SIC(^c) ((\beta_s))</td>
<td>Benefits ((\beta_b))</td>
<td>Income tax and SIC(^c)</td>
</tr>
<tr>
<td>AT</td>
<td>16.4</td>
<td>7.7</td>
<td>0.0</td>
<td>36</td>
</tr>
<tr>
<td>BE</td>
<td>13.7</td>
<td>8.5</td>
<td>-0.3</td>
<td>38</td>
</tr>
<tr>
<td>DK</td>
<td>11.4</td>
<td>8.1</td>
<td>-0.6</td>
<td>49</td>
</tr>
<tr>
<td>FI</td>
<td>11.3</td>
<td>8.3</td>
<td>-0.2</td>
<td>42</td>
</tr>
<tr>
<td>FR</td>
<td>9.1</td>
<td>8.1</td>
<td>-0.6</td>
<td>31</td>
</tr>
<tr>
<td>GE</td>
<td>17.5</td>
<td>7.5</td>
<td>-0.6</td>
<td>36</td>
</tr>
<tr>
<td>GR</td>
<td>14.5</td>
<td>5.3</td>
<td>0.0</td>
<td>28</td>
</tr>
<tr>
<td>IR</td>
<td>18.8</td>
<td>10.9</td>
<td>-0.5</td>
<td>21</td>
</tr>
<tr>
<td>IT</td>
<td>11.2</td>
<td>8.4</td>
<td>-0.3</td>
<td>31</td>
</tr>
<tr>
<td>NL</td>
<td>19.0</td>
<td>5.8</td>
<td>-0.4</td>
<td>35</td>
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<td>PT</td>
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<td>-0.4</td>
<td>25</td>
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<tr>
<td>SP</td>
<td>16.4</td>
<td>3.8</td>
<td>0.0</td>
<td>22</td>
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<tr>
<td>SW</td>
<td>10.7</td>
<td>4.7</td>
<td>-0.5</td>
<td>42</td>
</tr>
<tr>
<td>UK</td>
<td>12.0</td>
<td>9.0</td>
<td>-0.5</td>
<td>25</td>
</tr>
</tbody>
</table>

\(a\) Percentage change from baseline value due to a 10\% change in earnings (marginal income elasticity)
\(b\) Percentage share in gross household income
\(c\) Social Insurance Contributions

Source: EUROMOD, own calculations based on Mabbett (2004)

The first three columns tell us, to take the example of Austria (AT), that for a 10\% increase in earnings, income taxes respond strongly in that they increase by 16.4\%. By contrast, SIC rise a less than proportional 7.7\%; and benefits decrease hardly at all.\(^{15}\) It can be seen that, for all countries except France, income tax rises by more than 10\% (elasticity with respect to earnings is greater than 1), while the converse is true for SICs in all countries except Ireland. The values for the stabilisation coefficient in the last column range from 0.31 for Spain to 0.57 for Denmark. In other words, the tax and benefit system reduces the fluctuations of disposable income by one-third to more than one-half. This is consistent with the estimates of coefficients of 0.25-0.3 for the USA generated by Auerbach and Feenberg (2000) using a similar methodology (we would expect European values to be higher, because European welfare states are larger). The ranking of countries is also broadly consistent with the study of the cyclical responsiveness of government budgets by van den Noord (2000).

\(^{15}\) In principle, it is possible to simulate the change in (un)employment status related to a rise in earnings by using Okun’s Law (Mabbett, 2004, p.10, table 3). This would increase the size of stabilisers on the benefit side.
Since we argued that the net impact of Lisbon-type reforms will depend on which determinant is more dominant, it is of interest to disentangle whether responsiveness or weight contributes more to the stabilisation coefficients in our set of countries. As chart 1 (disregarding benefits) illustrates, weight is the dominant determinant. Stabilisation coefficients are positively correlated with weight (the black dots follow a rising trend) while no such relationship is discernible for responsiveness (the square and triangle data points do not follow a rising or declining trend). We can also see that Denmark and Finland, to the right of the graph (i.e. with high values for the stabilisation coefficient) have relatively unresponsive tax and SIC structures, yet their weight compensates this. Conversely, Ireland has the lowest weight of taxes and SICs in household income, but high responsiveness (the square and triangle data points are in the upper band of the two data series). Ireland’s stabilisation coefficient is high given the small size of its government, although it is still below the EU average of 0.45.

Chart 1: Determinants of the size of automatic stabilisers

The immediate conclusion for tax reforms is, first, that income tax and SIC reforms are central to what is going to happen to automatic stabilisers, because it is unlikely that the responsiveness of benefits can be massively increased, given that entitlements typically do not depend on income alone. A second conclusion is that lowering average income taxes, to reduce the tax burden overall or by shifting some to indirect taxes, is likely to have a more pronounced weakening impact on automatic stabilisers (by reducing weight) than flattening marginal tax rates (which diminishes responsiveness). These conclusions are borne out by the fact that there is no low-weight (small government) country with a stabilisation coefficient above the average. The reverse does not hold, however. There are
fairly ‘weighty’ tax-benefit systems that do not achieve a corresponding stabilising effect (cf. France and Italy). Therefore weight helps but does not guarantee effective stabilisation.

Obviously, these simulations cannot but give a rough indication of what Lisbon-type reforms – making tax and benefit systems ‘more employment-friendly’ – would do to macroeconomic stabilisation. Yet these results shed some light on the debate about the link between structural reforms and fiscal consolidation. As outlined in s.1, we endorse the ‘need for bribes’ argument against procyclical consolidation. We have shown that Lisbon-type reforms could have the negative side-effect of weakening fiscal stabilisation. In other words, if we look at the causal link from another direction than the political economy literature has done so far, we find that structural reforms may contribute to adverse macroeconomic conditions by negatively affecting the conduct of countercyclical fiscal policy.

*Is effective automatic stabilisation bad for adjustment?*

Our conclusion from the EUROMOD simulations must address a possible objection that Buti and van den Noord (2003) formulate most forcefully: is this weakening of conventional demand stabilisation really a loss, once we take labour supply adjustments into account? Their answer is a resounding “No”. They claim that automatic stabilisers are not the solution but the problem in that they prevent adjustments to supply shocks, thus making for stability with high unemployment. Weakening them generates a double dividend of supply-side flexibility and more effective stabilisation through microeconomic adjustment.

The empirical data we used for our earlier analyses allows us to do a limited evaluation of this hypothesis. If it holds, tax-benefit systems that yield high stabilisation coefficients according to our EUROMOD simulations (table 2) should have both high levels of unemployment and low volatility of unemployment, the latter to be interpreted as persistence of unemployment.
As regards levels of unemployment, we find not a positive but a (weak) negative correlation: tax-benefit systems with stronger stabilising qualities or more generous unemployment benefits, respectively, had lower average unemployment rates in the period 1997-2004. The results for persistence or volatility of unemployment also fail to show the relationship hypothesised by Buti and van den Noord (2003) which implies a negative correlation (the higher the stabilisation coefficient, the lower volatility of unemployment).

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16 The Pearson correlation coefficient, assuming a value between 1 and -1, is -0.28 for the EUROMOD estimates of the stabilisation coefficient and would be even higher if the outlier Finland were disregarded.
We see this as evidence that demand stabilisation through automatic fiscal mechanisms does not increase unemployment and does not add to unemployment persistence. At least for our set of countries, the automatic stabilisers seem not to have adverse effects on employment and adjustment.

**Conclusions**

Our exploratory study suggests that Lisbon-type reforms, such as lowering the average tax burden and reducing effective marginal tax rates, are problematic from the point of view of fiscal stabilisation. This is because they would lower the weight and the responsiveness of member states’ tax systems to shocks and business cycle fluctuations. The potentially positive effects of reforms on the cyclical responsiveness of benefits are too small to compensate. Negative spillovers from structural reforms on the stabilising qualities of tax-benefit systems are particularly worrying for EMU members since they have little scope for discretionary fiscal policy. The current fiscal rules emphasise the role of the automatic stabilisers in the conduct of country-specific macroeconomic policy. This finding is relevant for the political economy of reform and European integration. The dual agenda of the EU induces governments to ask their electorates not only to accept that not all past commitments as regards old-age or unemployment benefits will be honoured but also that they will have to self-insure more volatile disposable incomes.

Our findings on the size of stabilisers, as summarized in table 2 and chart 1, contain some lessons for the ongoing restructuring of welfare states. First of all, if governments are mindful not only of microeconomic flexibility but also macroeconomic stability, they
may want to exploit the possibilities of raising the progressivity of taxes while lowering the overall tax burden. SICs are generally less progressive (responsive) than income taxes, so reform of social insurance contribution structures or substitution of taxes for SICs may improve the operation of the stabilisers. However, there is no continuous tradeoff between responsiveness and weight; progressivity cannot vary that much and has to be limited as government gets bigger. The empirical results reported here give little insight into the potential on the benefit side, but theory suggests that Lisbon-type benefit reforms may actually be constructive since their overall thrust is ‘activation’ which in the context of our study means to replace permanent transfers by temporary ones.

Finally, we would like to stress that, it is unlikely that fiscal stabilisation can be substituted by more flexible supply-side adjustment. As our discussion of Buti and van den Noord’s (2003) arguments indicated, privatizing social risk management does not appear to yield a double dividend of flexibilisation and stabilisation. Furthermore, we question the ‘back against the wall’ political economy which suggests that the absence of countercyclical macroeconomic policy will strengthen incentives to reform. On the contrary, we see adverse macroeconomic conditions as making welfare reforms more difficult, and we have shown that such reforms may contribute to macroeconomic instability. This suggests that recent attempts to ‘streamline’ (link) fiscal policy coordination and the Lisbon process (CEC, 2005b) should pay more attention to the compatibility of welfare state reforms and macroeconomic policy.

References:


**Appendix: Analysis of National Action Plans on Employment 2004**

<table>
<thead>
<tr>
<th></th>
<th>Average taxes and contributions</th>
<th>Marginal taxes</th>
<th>Non-employment benefits</th>
<th>Employment protection legislation</th>
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</thead>
<tbody>
<tr>
<td><strong>AU</strong></td>
<td>Tax reform 2004: preferential tax treatment of undrawn profits of up to €100,000; reduce corporate tax rate from 34% to 25% [12]; lower non-wage labour costs for elder workers [12]</td>
<td>Tax reform 2004: no taxes to be paid on earnings below €14,500 [12]; Raise tax-free earnings, of a total of 5.9 million (potential) taxpayers, 2.4 million pay not wage or income taxes [30]; Simplified tax structure of only 4 tax brackets, including a 0% bracket [30]</td>
<td>‘Greater labour market dynamics’ through reformed ‘job suitability conditions’ [16]</td>
<td>--</td>
</tr>
<tr>
<td><strong>BE</strong></td>
<td>Lower tax burden for low and average wage earners in particular for the low-paid [52]</td>
<td>Existing tax credit to be enhanced by decrease of employers’ contribution for low paid employees, amounts to max €440 p.a. [14]; Degressive reduction of employer SIC, recently ‘some flattening for the highest wages’, reduction of €400 or €1000 per quarter for employing defined target groups [25, 27]; Employee SIC will be reduced through work bonus scheme [27, 53]</td>
<td>Stricter conditions as regards acceptance of jobs, only minimum social welfare benefit for refusal [21]; subsidised employment with local authorities or in the non-profit sector [23]; Address unemployment trap of high replacement rate of 91.3% not by lower or shorter duration of unemployment benefits but by stricter enforcement of obligation to seek work [54]</td>
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<thead>
<tr>
<th>Country</th>
<th>Average taxes and contributions</th>
<th>Marginal taxes</th>
<th>Non-employment benefits</th>
<th>Employment protection legislation</th>
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<tr>
<td>DK</td>
<td>Lower average taxes on earned income through ‘employment allowance’ and extension of middle-bracket taxation [47-48]</td>
<td>Lower marginal tax rates, in particular for middle and high-tax brackets, from 59.3% in 1993 to 51.9% in 2006 [7, 48-49]</td>
<td>Voluntary early retirement pay scheme raises retirement age [6, 35]; Stricter availability and entitlement requirements [11-12]; radical reform: ‘individual approach in employment measures with a clear job orientation’, mostly in terms of active placement and simplified procedures [22-23]; use of wage subsidies for public and private jobs exceeded target, 40% in private sector [25]</td>
<td>Already flexible rules on recruitment and dismissals, in particular short dismissal periods; but high and good access to non-employment benefits also guarantee security [28-29]</td>
</tr>
<tr>
<td>FI</td>
<td>Tax cuts for low and mid-income brackets [6]; reduction of corporate (from 29 to 26%) and capital taxes (29%) to ensure competitiveness [9, 18]; tax wedge reduced by about 5% [37]; Cut income taxes by more than contributions to pensions rise [37]</td>
<td>‘improve incentives for offering and accepting work, especially in low-productivity sectors’ [17]</td>
<td>Reform of employment agencies to, inter alia, reduce social assistance and unemployment benefits [14]</td>
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<td></td>
<td>Average taxes and contributions</td>
<td>Marginal taxes</td>
<td>Non-employment benefits</td>
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<tr>
<td>GE</td>
<td>‘will provide relief for the factor labour by cutting non-wage labour costs’ [6], reduction in corporate taxes [8] decrease of SIC [38] introduction of taxation of pensions by 2040 [38]</td>
<td>Basic income tax rate reduced to 16% (compared to 25.9% in 1998), top rate to 45% (compared to 53% in 1998), basic tax free allowance increased to €7,664 (compared to €6,332 in ’98) [8, 39] Increased earnings allowance for beneficiaries of means-tested NEB (€1,500 compared to €700) [37]</td>
<td>‘pooling of unemployment assistance and social welfare’ in Basic Security of Job Seekers [7, 12], ‘actively supporting and demanding’ as basic philosophy asks for more ‘initiative’ of unemployed persons [7, 38] reducing maximum number of months of receiving unemployment benefits to 12/18 months resp (&lt;55/&gt;55 year olds) [36-37]</td>
<td>‘expanding the mini-job regulation’ [7], ‘flexible dismissal protection’: Protection against Dismissal Act applies to firms with 10 or more employees [19] regulations of fixed-term contracts ‘amended’ to promote job creation in small companies [19] part-time work reform to ‘enhance flexibility’ [20-21]</td>
</tr>
<tr>
<td>Country</td>
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<tr>
<td>GR</td>
<td>‘reduction of today’s oppressive taxation of enterprises’ [13]</td>
<td>Subsidies for employer SIC if firms hire young/ longterm unemployed or mothers [19] Increased earnings allowances for the unemployed [22-23] Law converting unemployment benefits into employment benefits ‘indirectly reducing non-wage labour costs’ [47]</td>
<td>Unemployment benefits of such low level and short duration that disincentives are not an issue [47]</td>
<td>Creation of Companies of Temporary Employment [31] Public sector jobs for target groups subject to private law on temporary work [33]</td>
</tr>
</tbody>
</table>
| IR      | ‘alleviating the tax pressure on labour, in particularly the low paid’ [55] Lowest tax wedge already [56] | Employee ax credit increased (from annually €800 to €1,040) so that 90% on minimum wage are tax exempt [56] Remove disincentives in social security schemes such as increased earnings allowance and retention of housing benefits [57] | ‘moving resources spent on passive income support measures to active measures’ [55] | Any employee working for a regular salary has a contract of employment whether written or not; employment legislation covers all workers [28] Improved protection for fixed-term workers [29] Increased paternal leave opportunities and maternity protection [29]
<table>
<thead>
<tr>
<th>Country</th>
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<th>Non-employment benefits</th>
<th>Employment protection legislation</th>
</tr>
</thead>
<tbody>
<tr>
<td>IT</td>
<td>Proposal under study: just two tax rates of 23% (up to €33,000 earnings) and 33% plus an earmarked ‘ethical tax’ on high incomes [24-25]</td>
<td>Proposal under study: increased earnings allowances [24], Tax credit for new employment [33]</td>
<td>‘strengthening of the insurance logic and action to prevent longterm unemployment’ [25]</td>
<td>‘promoting regular, non-precarious, properly regulated employment’ of a non-conventional sort (job sharing, intermittent, casual and extra work) to prevent labour market segmentation (Council rec.) [10, 18, 33]</td>
</tr>
<tr>
<td>NL</td>
<td>--</td>
<td>Increase in two types of tax credit and reduction of special welfare benefit to deal with ‘inactivity trap’ [29-30]; reform of income-dependent benefits such that move from part to full-time work becomes more attractive [15]; employer tax credit for employing older workers [20]</td>
<td>Favourable tax treatment of early retirement schemes are phased out [6, 20], reassessment of disabled persons below 55 under tighter standards [21]; ‘work above income’ as a principle, i.e. subsidised labour as the main reintegration tool [9]</td>
<td>Removing ‘unnecessary obstacles in dismissal procedures’ [13]</td>
</tr>
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<td></td>
<td>Average taxes and contributions</td>
<td>Marginal taxes</td>
<td>Non-employment benefits</td>
<td>Employment protection legislation</td>
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<tr>
<td>PT</td>
<td>--</td>
<td>Compensation/wage subsidy for accepting a fulltime job with a lower than previous salary [32];</td>
<td>‘Clause’ ensures that sickness and unemployment benefits must not exceed net wage [32]; stricter conditions as regards refusal of job offers [32]</td>
<td>Labour Code re-regulation to make working at home more flexible, protect young and night workers [16]; Financial incentives for employers to convert fixed-term into permanent contracts (Council rec.) [18]</td>
</tr>
<tr>
<td>SP</td>
<td>Policy of reducing labour costs through lower SIC is under review by social dialogue [19]; general reduction of income tax rates by about 3% [44]</td>
<td>Earnings allowances introduced for transition into employment [43]; Increased tax credits for wage income and for low incomes [44]</td>
<td>Unemployed persons forming or joining a workers’ cooperative can receive their benefits as a lump sum [19]; Recipients must take part in ‘employability measures’ [43]; Unemployment benefits will be increased in line with minimum wage [44]</td>
<td>Increase of statutory minimum wage by 6.6% [43]; Reduced SIC for employers converting fixed-term into permanent contracts [43]</td>
</tr>
<tr>
<td>SW</td>
<td>Extensive tax reform launched in 2000 to reduce average tax rate for low and middle income earners through lump-sum reduction of 2,400 SK [48-49]</td>
<td>average marginal effective tax rate reduced by 6% since 1997 [48] but marginal rate still very high for those on unemployment benefits (75%) or sick leave (82%) [48-49]</td>
<td>Combining generous level of unemployment benefits with ‘the requirement to adjust’[13, 50], after 100 days on benefits, recipients must extend job search in geographical and occupational terms [16]</td>
<td>Given increase in non-standard contracts, legislative amendments to clarify workers’ rights as regards working time etc [22]</td>
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<td></td>
<td>Average taxes and contributions</td>
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<tr>
<td>UK</td>
<td>--</td>
<td>Tax credits for lone parents to provide in-work financial support [17]; Child and Working Tax Credits for families with children; disregard of up to £2,500 additional earnings before tax credit is affected, taper rate of 37% to create stronger incentives for secondary part-time earners [25]</td>
<td>Increase in disregard of housing benefits [26]</td>
<td>Increase of statutory minimum wage [25]</td>
</tr>
</tbody>
</table>