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Up-to-the-Minute Analysis from
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Two Steps to Avert Another Eurozone Crisis: A Coordinated Cut in the Tax Wedge and Smart Implementation of the Stability and Growth Pact

Testing times from the very start. That is the fate of President-elect Jean-Claude Juncker's new European Commission as it takes office amidst rising difficulties for the flailing eurozone economy. The upbeat narrative of just a short while ago – of a budding recovery spurred by past reforms and an easing of fiscal austerity – has given way to deep concerns as growth flags and market tensions rise. The risks ahead are considerable. To avert them, there is a mounting consensus on the need for a three-pronged response, made of easy money, growth-friendly fiscal policies and structural reforms.[1]

This consensus, however, lies more in words than in deeds, with a continuing chasm between European declarations and actions. Bridging this gulf would require a "grand bargain" – an institution-wide agreement in which all economic players contribute to the required monetary, fiscal and structural policy mix.[2] The sealing of any such bargain, however, is remote. A more modest, and thus more realistic approach, is that of ensuring that each of the major players, individually, delivers in the areas of its responsibility. This could be seen as an application, at European Union-level, of the international prescription

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[1] Mario Draghi, president of the European Central Bank, gave the most thoughtful exposition of this vision to date in his 22 August 2014 speech in Jackson Hole, prompting some wags to nickname the position "Draghinomics." http://www.ecb.europa.eu/press/key/date/2014/html/sp140822.en.html
[2] For an illustration of what such a "grand bargain" might entail look, see Alessandro Leipold, *Interpreting the Stability and Growth Pact: Making Best Use of Existing Flexibility Within the Rules* (Brussels: The Lisbon Council, 2014). The "grand bargain" table presented in that paper is reprinted in this Economic Intelligence briefing as an appendix on page 10.
http://www.lisboncouncil.net//index.php?option=com_downloads&id=1055

whereby a necessary step for welfare-improving outcomes is that all agents keep their own house in order, by in essence delivering on their mandate.[3]

In this Economic Intelligence briefing, we will focus on what needs to be done in the immediate future to live up to this prescription, partly in an effort to help the new European Commission start its term off on the right foot. It is of course evident that the European Commission is just one of the players on the scene, and that progress depends ultimately on decisions and actions of the European Council and individual EU member states. There are in essence two early critical tasks:

1. An assessment – requested by the eurogroup at its 12 September 2014 meeting in Milan – of euro area members' plans to reduce the tax wedge on labour.[4]

2. The formulation of opinions on member states' budgetary plans for 2015 and the medium term, as per the European semester calendar.

Both of these items are likely to be discussed at the European Councils of 23-24 October 2014 and 18 December 2014, when the first European Council to be attended by President Juncker in his full capacity as European Commission President will gather. Both items are critical to Europe's growth prospects. There is of course a third major item on which Europe will be called to deliver: the incoming European Commission President's plan for additional public and private investment of up to €300 billion. Important as this is, the commitment is to present this initiative within the first three months of the new president's mandate, i.e., somewhat beyond the immediate, year-end horizon of this Economic Intelligence briefing. Suffice it to say that for the investment initiative to be at all meaningful, it will require far greater specification of the breakdown between private and public funds, and identification of the means to mobilise the latter. This will need to go beyond the hoary mantra of leveraging the European Investment Bank and making better use of EU structural funds – a *deus ex machina* that has been regularly invoked and just as regularly failed to materialise.

Step 1. Structural Reforms: A Coordinated Cut of the Tax Wedge

The call for structural reforms throughout Europe – no country excluded – has by now become so familiar as to have lost much of its efficacy. In truth, invocations from the centre for such reforms have never had much traction. Old European hands will remember the dispiriting experience with the Broad Economic Policy Guidelines, the Lisbon Agenda and other similar initiatives. Their successors – the Annual Growth Survey, the country-specific recommendations, the macroeconomic imbalances procedure and the Europe 2020 Strategy – have had scantly greater success.

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[3] Stanley Fischer, vice chairman of the Federal Reserve board of governors, put it this way on 11 October 2014 in his Per Jacobsson Lecture: "The most important contribution that US policymakers can make to the health of the world economy is to keep our own house in order – and the same goes for all countries." http://www.federalreserve.gov/newsevents/speech/fischer20141011a.pdf

[4] Eurogroup, *Structural Reform Agenda: Thematic Discussions on Growth and Jobs - Common Principles for Reforms Reducing the Tax Burden on Labour*, Milan, 12 September 2014. http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/144872.pdf

What is needed is a change of tack. Instead of incessantly calling on individual countries to implement reforms, the European Commission and the European Council should identify important reforms needed by most countries and set them as common priorities to be implemented jointly. A notable start in this direction has indeed been made. The eurogroup meeting of 08 July 2014 identified the tax burden on labour – and specifically a high tax wedge – as a pressing issue in 11 member states.[5] The approach embodied two useful innovations. First, it made practical and concrete use of the country-specific recommendations, drawing on them to identify a commonly-needed reform. Second, it named the 11 countries concerned, not shirking (as habitual) from a form of "naming and shaming," albeit of a mild variety.[6] A subsequent eurogroup meeting in Milan on 12 September 2014 went further: it made a cogent case of the benefits of a reduction of the tax burden on labour, set it as "a clear policy priority," and agreed on a set of common reform principles. It undertook to take stock of national plans in this regard when discussing member states' budgetary plans in November, based on a European Commission assessment.[7]

The elevation of a reduction in the tax wedge as a clear area-wide policy priority is appropriate from three angles:

- **The tax burden on labour is inordinately high in Europe.** OECD data indicate that the 15 advanced countries with the largest tax wedge are all European (see the table on page 4 for a full OECD comparison). Belgium tops the list with a tax wedge of almost 56%, while Germany, Austria, Hungary, France and Italy are all close to 50%. Indeed, only the United Kingdom and Ireland (as well as Cyprus and Malta, not shown in the table) are below Japan and comparable to, or better than, the United States. Furthermore, as a result of fiscal consolidation, the average tax burden on labour in the euro area has been rising over the last few years, pushed in particular

[5] The tax wedge is the difference between the labour cost paid by the employer and the corresponding net take-home pay of the employee due to income tax and social security contributions; it is expressed as a percentage of labour costs.
[6] The 11 countries are Austria, Belgium, Estonia, France, Germany, Italy, Latvia, Luxembourg, the Netherlands, Portugal and Spain. See Eurogroup, *Structural Reform Agenda: Thematic Discussions on Growth and Jobs—Reduction of the Tax Wedge*, Brussels, 08 July 2014.
http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/143678.pdf
Recently, the new Belgian government has made a reduction of labour taxes a central plank of its programme, and it features prominently also in Italian Prime Minister Mateo Renzi's government's 2015 draft budget.
[7] Eurogroup, *Structural Reform Agenda: Thematic Discussions on Growth and Jobs – Common Principles for Reforms Reducing the Tax Burden on Labour*, op. cit.

Tax wedge (2013) in OECD countries
As a percentage of overall labour costs (1)

Rank	Country	Total tax wedge
1	Belgium	55.8%
2	Germany	49.3%
3	Austria	49.1%
4	Hungary	49.0%
5	France	48.9%
6	Italy	47.8%
7	Finland	43.1%
8	Sweden	42.9%
9	Czech Republic	42.4%
10	Slovenia	42.3%
11	Greece	41.6%
12	Portugal	41.1%
	Slovak Republic	41.1%
14	Spain	40.7%
15	Estonia	39.9%
16	Turkey	38.6%
17	Denmark	38.2%
18	Norway	37.3%
19	Luxembourg	37.0%
20	Netherlands	36.9%
21	Poland	35.6%
22	Iceland	33.4%
23	Japan	31.6%
24	United Kingdom	31.5%
25	United States	31.3%
26	Canada	31.1%
27	Australia	27.4%
28	Ireland	26.6%
29	Switzerland	22.0%
30	Korea	21.4%
31	Israel	20.7%
32	Mexico	19.2%
33	New Zealand	16.9%
34	Chile	7.0%

(1) The figure is calculated for a single individual without children at the income level of the average worker. Source: OECD http://www.oecd-ilibrary.org/taxation/taxing-wages-2014_tax_wages-2014-en

by developments in peripheral economies.[8] As to the components of the tax wedge, Denmark records the highest percentage of labour tax paid in income taxes (35.8%), while employers in France pay 28.7% of total labour costs in social security contributions, the highest amongst OECD countries.[9]

- **Such a high tax wedge is a major impediment to getting Europe's 24.6 million unemployed back to work**. A large body of empirical and econometric studies provides overwhelming evidence that a higher labour tax wedge raises unemployment, with highly significant coefficients across a wide range of alternative specifications. The precise effects differ across countries, depending on complex interactions with labour market institutions.[10]

- **Conversely, a reduction in the tax wedge has appreciable employment payoffs.** A smaller tax wedge can significantly raise labour supply and employment over the medium term. Specifically, it has been estimated that a 10 percentage reduction in the tax wedge is associated, on average, with a drop in structural unemployment (that is, unemployment not caused by weaknesses in aggregate demand) of 2.8 percentage points, and an increase in the participation rate by a larger 3.7 percentage points. In the specific cases of Ireland and the United Kingdom, the reductions in the tax wedge observed in the 1983-2003 period are estimated to have lowered equilibrium unemployment by more than five and three percentage points, respectively.[11]

The eurogroup's priority is thus well-placed, but it still shies from joint action, leaving the initiative to individual member states. More grievously, on the critical issue of the financing of the reforms, the eurogroup's set of principles insists that the reform's costs "be duly compensated" by spending cuts or shifts to other taxes "with a view to respecting fiscal targets in line with the stability and growth pact." This is a limiting and self-defeating prescription, at odds with the pact's flexibility under its "structural reforms" clause.

What could the European Commission's assessment of the tax wedge initiative, requested by the eurogroup, usefully recommend? There are two key elements:

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[8] Eurostat, *Wages and Labour Costs* (Luxembourg: Eurostat, March 2014). http://epp.eurostat.ec.europa.eu/statistics_explained/index.php/Wages_and_labour_costs#Tax_wedge

[9] OECD, *Taxing Wages 2014* (Paris: OECD, 2014). http://www.oecd-ilibrary.org/taxation/taxing-wages-2014_tax_wages-2014-en With regard to Denmark, it should be noted that Scandinavian countries have achieved high employment ratios despite high taxation (including on labour) by imposing strict eligibility and job search requirements, a combination that requires strong administrative capacity and a broad social consensus.

[10] A comprehensive review of the evidence is provided in *OECD Employment Outlook 2006, Boosting Jobs and Incomes* (Paris: OECD, 2006). http://www.oecd.org/els/emp/36889821.pdf

[11] Andrea Bassanini and Romain Duval, *Employment Patterns in OECD Countries: Reassessing the Role of Policies and Institutions*, OECD Social, Employment and Migration Working Papers No. 35 (Paris: OECD, 2006). https://ideas.repec.org/p/oec/elsaab/35-en.html

- **Make a strong case for joint and common action.** Ample literature has concluded that cross-country coordination of reforms produces larger and more evenly distributed positive effects than national efforts on their own.[12] Indeed, calls for coordinated structural reforms within Europe abound.[13] This coordination goal has however remained elusive. The identification of a reduction in the tax wedge as a clear policy priority, shared by a majority of euro area members, offers a golden opportunity to move forward on this front. Indeed, the eurogroup's September statement noted the benefits of "a coordinated euro area approach." The European Commission should take ministers at their word in the requested assessment, and present a plan for a joint and common tax-wedge reduction programme. The potential economic benefits of such a collective step can hardly be overstated. It would furthermore give "teeth" to the country-specific recommendations and the associated European semester process.

- **Support use of fiscal flexibility under the stability and growth pact's "structural reforms" clause.** Econometric analysis suggests that, all else equal, cutting the tax wedge by 1 percentage point is, on average, associated with a revenue loss of 0.3 percent of gross domestic product.[14] It is thus clear that bringing the average euro area tax wedge to US levels would be prohibitively costly for the area's fiscal accounts (the required 15 percentage point reduction would entail a revenue loss of around 4.5% of GDP). But a first, albeit appreciably more modest, step in this direction is feasible, and should be accommodated by making full use of the flexibility under existing stability and growth pact rules. President-elect Juncker himself, in presenting the agenda for the new European Commission, stressed the importance of "making the best possible use of the flexibility that is built into the existing rules of the pact," and added: "I intend to issue concrete guidance on this as part of my ambitious jobs, growth and investment package."[15]

Such guidance should clarify that existing rules allow deviations from the pre-set adjustment path precisely to cover the costs of structural reforms that are seen as "raising potential sustainable growth."[16] As noted, the reform's payoffs are indisputable, and were stressed by

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[12] See Janos Varga and Jan in 't Veld, "The Growth Impact of Structural Reforms," *European Commission Quarterly Report on the Euro Area*, Vol.12/4, December 2013 (Brussels: European Commission, 2013).
http://ec.europa.eu/economy_finance/publications/qr_euro_area/2013/pdf/qrea4_en.pdf

[13] Such calls – once limited to academics – are now being made by senior policymakers as well, including German Finance Minister Wolfgang Schäuble and his Italian counterpart Pier Carlo Padoan in a joint article in *The Wall Street Journal,* http://online.wsj.com/articles/europe-needs-a-pro-growth-agenda-1403809631 and ECB President Mario Draghi at the Jackson Hole symposium. http://www.ecb.europa.eu/press/key/date/2014/html/sp140822.en.html

[14] International Monetary Fund, "Back to Work: How Fiscal Policy Can Help," *Fiscal Monitor October 2014* (Washington; IMF, 2014). http://www.imf.org/external/pubs/ft/fm/2014/02/pdf/text.pdf

[15] Jean-Claude Juncker, *A New Start for Europe: My Agenda for Jobs, Growth, Fairness and Democratic Change, Political Guidelines for the Next European Commission*, 15 July 2014. http://ec.europa.eu/about/juncker-commission/docs/pg_en.pdf

[16] All quotations from the stability and growth pact rules are drawn from the pact's two main legislative documents, namely 1) Council Regulation 1466/97 as amended by Regulations 1055/2005 and 1175/2011,

eurogroup ministers themselves ("reducing the tax burden on labour has the potential to support consumption, stimulate labour supply and employment, as well as improve cost competitiveness and firms' profitability... contributing to the smooth functioning of European Monetary Union"). Surely, such an exemplary case fully warrants recourse to the stability and growth pact's "structural reforms" flexibility clause. Countries with truly limited fiscal space could be required to secure financing via spending cuts that are locked in at the outset but due to take effect only in the future. This overall approach should be an integral part of President Juncker's "concrete guidance" on the application of stability and growth pact flexibility. In its absence, one would have to wonder: if not now, and for such a declared "policy priority" as the reduction of the tax wedge on labour, when would the pact's flexibility for structural reforms ever be applied?

In sum, a joint and coordinated reduction of the stiflingly high tax wedge in 11 (and possibly more) euro area member states, and a conscientious application of the flexibility under the existing stability and growth pact rules to create room for its financing, would provide a significant fillip to confidence, employment and growth in the euro area, at a time in which it is sorely needed. Combined with genuine delivery of the first instalment of the announced €300 billion investment plan in early 2015, and further action by the European Central Bank, it would serve to stem and reverse current adverse trends.

Step 2. A Smart Assessment for Member States' Fiscal Plans: France v. Italy

Among the new European Commission's tasks in its first month in office will be the assessment of member states' fiscal plans for 2015 and beyond. (Although a first assessment is to be provided by the outgoing European Commission at the last meeting of its mandate in late October, this is unlikely to be the final word.) Such assessments are a complex process, given the intricacy of EU fiscal rules and the technicalities of the calculations involved (notably of potential output and of related structural fiscal balances). Given such complexity, and with the full details of several countries' budgets still not publically known (though supposedly submitted to Brussels by the 15 October 2014 deadline), concrete suggestions as to the substance of the assessments are not at this stage possible.

Sufficient facts are however known to express a view on the issue that has captivated the media: the positions of France and Italy and their treatment under the stability and growth pact. In France, the dreaded outcome is an out-and-out rejection of its budget plan, with a "return to sender" for redrafting, given its avowed violation of the stability pact's parameters.

France's brash approach has raised fears that contagion may cross the Alps into Italy. Specifically, the concern is that the opportunity might be seized to castigate both countries' misconduct. EU procedures do not however unfold in this manner. The assessment of

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http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:1997R1466:20111213:EN:PDF
and 2) Council Regulation 1467/97 as amended by Regulations 1056/2005 and 1177/2011.
http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:1997R1467:20111213:EN:PDF
See also Leipold, *Interpreting the Stability and Growth Pact: Making Best Use of the Existing Flexibility Within the Rules,* op. cit.

whether the fiscal rules are formally observed is carried out by aptly named technocrats. As such, they comb through the complex set of requirements from an essentially legal and technical perspective. No doubt, technocrats also internalise the prevailing political constraints, but the specificity of the rules limits their degree of discretion. The political discretion of the Economic and Financial Affairs Council of the European Union is in turn contained by the provisions of the "six pack." To avoid episodes such as the notorious Franco-German non-compliance of 2003, the European Commission's recommendations are considered approved unless there is a contrary Council decision on a qualified majority vote – a cumbersome and thus unlikely procedure.

This procedural framework provides some safeguards for Italy and sets it clearly apart from France. First and foremost, the two countries are in diametrically opposite situations under the stability and growth pact: France is in the so-called "corrective arm," i.e., subject to an infringement procedure for having long posted a fiscal deficit in excess of the 3% of GDP limit, and planning one of 4.3% of GDP in 2015. Italy, in contrast, observes this limit and, while critical of its rationale, says it intends to continue to do so (even if only by a whisker, in its 2015 plans). Italy is therefore in the pact's "preventive arm," along with all countries seen to be virtuous. This distinction is critical when it comes to applying the margins of flexibility under the pact's current rules.[17]

In addition, Italy – unlike France – can rightfully claim to be going through "exceptional circumstances." When such circumstances prevail, a country is permitted to breach the 3% of GDP deficit limit temporarily, without triggering the pact's corrective procedures. Exceptional circumstances are defined as "an unusual event outside the control of the member state concerned" or as "periods of severe economic downturn," due to "a negative annual GDP volume growth or an accumulated loss of output during a protracted period of very low annual GDP volume growth relative to potential." Recently revised data for Italy show an even grimmer picture than previously reported, wiping out the one quarter (2013-Q4) of marginally positive growth. The country has thus recorded negative (or nil) growth in each of the last 12 quarters, i.e., uninterruptedly since early 2011, for a cumulative three years. Its output gap with respect to potential is estimated by the International Monetary Fund at 4.3 percentage points. If these are not exceptional circumstances, one wonders what ever will be. France, to its relative good fortune, cannot claim the same justification for the weakness of its public accounts, with GDP expanding every year since 2009.

There is however the vexed question of progress toward the medium-term objective of structural balance, where Italy could be caught out, having announced a minimal adjustment pace, well below the designated 0.7%, thus postponing achievement of structural balance to 2017. This is *a fortiori* true in the case of France. Here, too, the stability and growth pact's "structural reforms" flexibility clause could come into play, hence both countries' rush to prove their reform credentials. In the preventive arm (Italy's case), the clause allows a temporary deviation from a country's prescribed adjustment path toward its medium-term objective, in the presence of enacted and fully effective reforms – provided a safety margin

[17] See Leipold, *Interpreting the Stability and Growth Pact,* op. cit.

vis-à-vis the 3% ceiling is maintained (not the case). The leniency under the corrective arm (France's case) is much less: structural reforms can slow the gradual build up of pressures under the excessive deficit procedure (ultimately leading to pecuniary sanctions). Here, too, there is a fairly strict proviso: the deficit must be expected to return to the medium-term objective within the three-year period covered in the stability programme (not the case for France).

There are however specific critiques – advanced most fully by Italy – with respect to the EU's methodology for calculating potential output, and thus the structural balance, which underestimates the country's effort. The technicalities of the issue go beyond the confines of this Economic Intelligence briefing, and it would in any event not be possible for the European Commission to employ any other but the commonly agreed methodology. But the merits of the criticisms deserve being taken qualitatively into account in the assessment of fiscal plans and related fiscal effort. As Carlo Cottarelli, Italy's outgoing commissioner for public spending reform, puts it, in interpreting observance of the EU rules, due attention should be paid to "the risk that we may be underestimating the degree of structural adjustment that has taken place, and that is planned by countries, to avoid the risk of running procyclical fiscal policies."[18] It may be noted in this regard that the IMF puts Italy's structural deficit in 2015 at 0.5% of GDP - clearly not far from the medium-term objective (the corresponding figure for France is a deficit of 2.8 % of GDP).

In sum, Italy is not France, and there are no grounds for similar treatment under the fiscal rules. What is needed in the current environment is not any exemplary treatment of two supposedly wayward pupils, but a lucid distinction between the two cases based on the rules. Above all, given the gathering clouds on Europe, the stability and growth pact must be implemented smartly, fully using all the provisions that are designed to avoid procyclical impulses and encourage reforms and investment, in the context of the oft-invoked "growth-friendly fiscal adjustment." As is known, the stability and growth pact is under heavy critical fire from many quarters. Failure to apply it smartly, strengthening its economic underpinnings, could signify its ultimate demise. As seasoned a politician as the incoming European Commission President is no doubt fully cognizant of this risk. The European Council will need to demonstrate similar awareness.

It is crunch time for the EU's fiscal procedures. How the European Commission and the European Council handle these first, thorny cases may well determine their longer-term future. The hope is that they do so in a way that, while safeguarding the spirit of the stability and growth pact, also promotes the touted "new start for Europe," based on growth and employment.

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18 Carlo Cottarelli, *Speech at the Johns Hopkins School of Advanced International Studies (SAIS)*, Washington, DC, 10 October 2014 (*mimeo*). Commissioner Cottarelli further noted that under the current approach, "Italy's potential growth rate would be negative (by about a quarter percent in 2014-15). This means that any positive growth rate would reduce the output gap and, therefore, would require a reduction in the headline deficit just to keep the structural balance unchanged. This is really like swimming against the tide: you swim just to stay put."

Appendix: A grand bargain

Player	Action
European Council/ Eurogroup	• Specify meaning of "flexibility within rules" and support its full use • Aim for an aggregate supportive fiscal stance in the euro area, using the European semester's *ex ante* coordination • Work toward European Union-level coordination of structural reforms • Move rapidly on President-elect Juncker's investment plan, using scope under stability and growth pact rules • Revisit position on European Stability Mechanism direct bank recapitalisations as needed by stress test results • Complete single market (notably digital, energy and services)
European Commission	• Use European Commission discretion under the stability and growth pact to ensure growth-friendly consolidation • Rapidly adopt planned "jobs, growth and investment" package • Conduct review of "six-pack" and "two-pack" legislation (due by 14 December 2014) to ensure growth-friendly underpinnings • Cast annual growth survey and country-specific recommendations in terms of greater coordination (fiscal stances, structural reforms) • Conclude transatlantic trade and investment partnership with the US
European Central Bank	• Move to quantitative easing and other steps as needed • Resolutely ensure credibility of the asset quality review and stress tests
European Stability Mechanism	• Review European Stability Mechanism precautionary facilities and clarify their conditionality • Become an advocate of direct bank recapitalisations
Deficit countries	• Implement structural reforms • Proceed with growth-friendly adjustment as allowed by the flexibility in the pact • Address private debt overhang and non-performing loans
Surplus countries	• Implement structural reforms • Use available fiscal space; raise public investment • Address private debt overhang and non-performing loans
	Source: The Lisbon Council http://www.lisboncouncil.net//index.php?option=com_downloads&id=1055

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