

## TAXATION AND EMPLOYMENT IN THE EUROPEAN UNION

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### *Key Points*

- *The Policy of the European Union aims at a reduction of taxes on employed labour as one instrument to improve the employment situation*
- *Over the last decades the effective taxation of employed labour increased significantly stronger than the taxation of other productive factors (capital, self-employed labour) or consumption*
- *There is, for the Member States of the EU over the period 1980 – 1999, a correlation between increases in the effective taxation of employed labour and the increase in the unemployment rate*

### **1 Community Policy**

It is by now widely recognised that taxes levied on employed labour have an effect on the employment situation (see below). Consequently, the Employment Guidelines that are regularly drawn up by the Council on a proposal by the Commission include the recommendation to Member States to make their taxation systems more employment-friendly by reducing the overall tax burden and, where appropriate, also the fiscal pressure on labour in particular on relatively unskilled and low-paid labour.

The Employment Guidelines are transposed into concrete administrative measures by Member States through the National Action Plans on Employment that take into account the countries' particular situations. The Council examines the

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implementation of the Guidelines. In the annual Joint Employment Report, Commission and Council evaluate the progress made by Member States and, where necessary, give special recommendations.

## **2 Some Empirical Evidence**

Over the last decades total taxation has increased significantly in most Member States. In 1970 the total burden of tax (including compulsory social contributions) was 34.4 per cent (EU – 9 Member States), by 1980 it already stood at 38.3 per cent (EU – 15 Member States) and in 1997 it was 42.7 per cent. In the coming years a decline in the total tax burden is expected.

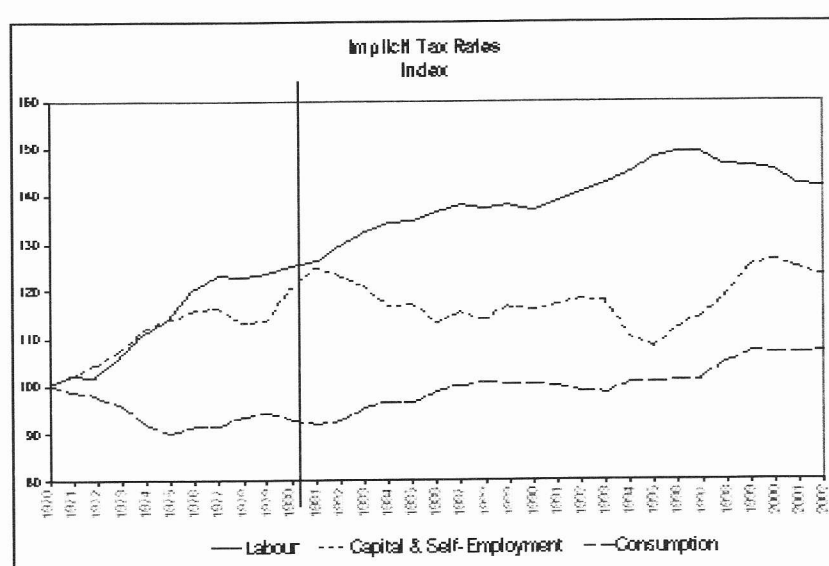
However, the increase in total taxation did not affect all productive factors in the same way (see Graph 1). The implicit tax rate<sup>2</sup> on employed labour increased from less than 30 per cent in 1970 (EU – 9 Member States) to almost 42 per cent in 1997 (EU – 15 Member States), i.e. the corresponding index increased by around 40 points. At the same time the taxation of capital and self-employment only increased from 30.4 per cent (EU – 9 Member States) to 31.1 per cent (EU – 15 Member States). Thus, despite relatively strong cyclical movements, the taxation of other factors than employed labour has remained remarkably constant over the last thirty years.

Only since 1996/97 there seems to be a change in the taxation of labour. The implicit tax rate is forecasted to decline from 41.2 per cent in 1998 to below 40 per cent by 2002. For the same period an increase in the rate of tax on capital and self-employment from 32.2 per cent to 33.5 per cent is expected.

Looking at the diverse picture of the EU, the negative effects of labour taxes on employment might not seem straightforward. There are countries where labour taxes and unemployment are low (e.g. Ireland, Luxembourg and the UK) and countries where both are rather high (e.g. Italy and Finland). But there are also some 'counter examples' with a relatively high taxation on labour but a relatively low unemployment rate (e.g. Denmark and Austria) as well as countries with a rather low level of labour taxation and high unemployment (e.g. Spain).

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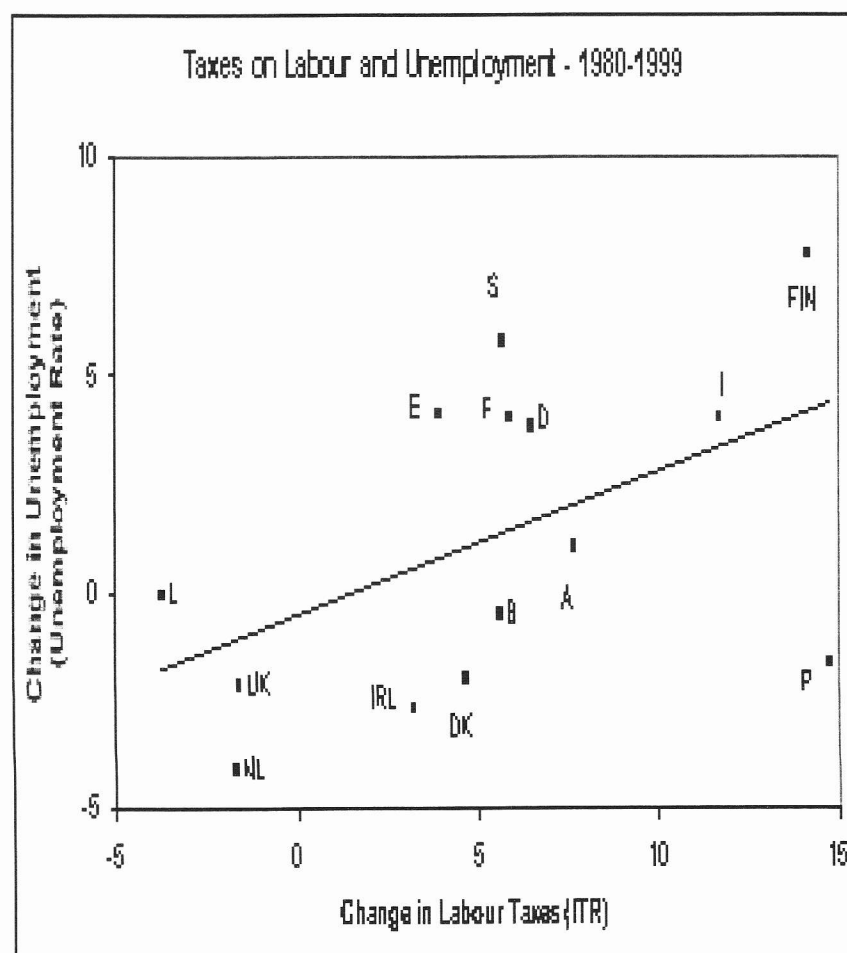
<sup>2</sup> The taxation of the productive factors (labour, capital) is best measured by implicit tax rates (sometimes called average effective tax rates). These rates show the relation between the tax revenues from labour taxes (or taxes on capital) in relation to the income from labour or capital (i.e. total gross earnings or total income from capital and entrepreneurial activities).

**Graph 1: Development of Implicit Tax Rates and Total Taxation since 1970**

Source: ESTAT, own calculations.

However, as soon as changes in taxation and their effects on the labour markets over time are considered, the relation between labour taxes and unemployment comes into much clearer focus. The effects of labour taxes on unemployment are primarily of a structural nature. As shown in Graph 2, there is also a relatively strong correlation between the increase in total taxation and the increase in unemployment. However, this is due to the fact that labour taxes make up one half of total taxation and thus changes in labour taxes have a strong parallel effect on total taxes. On their own, however, other taxes than labour taxes do not seem to have a great influence on employment. The statistical relation between unemployment and the taxation of capital and self-employed labour is relatively weak (+0.3) and there is no correlation between the taxation of consumption and unemployment.

In order to fight unemployment, targeted reductions in labour taxes seem therefore more appropriate than broad tax cuts that reduce all taxes in a similar degree.

**Graph 2: Changes in Labour Taxation and Unemployment**

Explanatory notes:

In order to minimise purely cyclical effects five-year averages were calculated for the implicit (effective) tax rate on employed labour and for the unemployment rate. The graph shows, on the horizontal axis, the absolute increase between the average implicit tax rate on employed labour in the period 1980/84 and the later period 1995/99. On the vertical axis the corresponding changes in the average unemployment rate are shown (i.e. average employment rate 1980/84 compared to

average employment rate 1995/99).<sup>3</sup> The resulting coefficient of correlation is +0.5, i.e. the increase in the average medium-term unemployment rate can be partly explained by the simultaneous increase in the effective taxation of employed labour.

Source: ESTAT, own calculations.

### **3 Some Theoretical Considerations**

Taxes on employed labour include all taxes on labour income as well as taxes that have to be paid due to the fact that labour is employed, i.e. they include taxes paid by employers (employers' social contributions, payroll taxes) and employees (income taxes, employees' social contributions).

The way in which labour taxes exercise their negative influence on employment depends to a large extent on the economy's wage setting mechanism. In Europe labour markets are, in many cases, rather inflexible. Thus labour taxes that are paid by the employers will to a large extent directly increase the cost of labour and provoke a substitution of labour by capital in the medium to long term. This is particularly true for low-qualified labour which, different from highly qualified work, can be largely substituted by capital. It might be noted that especially in the context of investment decisions the observed long lasting and stable trend of a steadily increasing labour taxation might be of greater importance than the actual level of labour taxation and labour costs. Such a trend will generate expectations of continuous future increases of labour costs and thus provoke a replacement of labour by capital even if the current level of labour taxation is not yet extremely high.

Employees will try to shift labour taxes to employers by higher wage demands and will thus add to the described cost-effects. Moreover, labour taxes borne by employees will reduce the incentive to offer labour in the white economy. The exact effects of labour taxes depend on the elasticity of labour supply and thus on demographic factors and but also on the system of social benefits. In particular for married women labour taxes act as a strong disincentive to take up work if the spouse is in employment. For low paid workers labour taxes might negatively affect the replacement rate so that relying on various social benefits might be more

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<sup>3</sup> Note that the data for Greece are not included since they would have exaggerated the relationship. The implicit tax rate of Greece increased drastically over the period under investigation but mainly as a result of more comprehensive statistics, not because of increases in the actual tax. Note also that the correlation might even be stronger since the increase in the labour taxes for Portugal might be overestimated due to statistical problems of identifying the part of labour taxes in the general Portuguese income tax.

attractive on work. Finally, labour taxes will increase the informal or shadow economy.