PREFACE

This volume initiates a new collaboration between Research in Labor Economics (RLE) published by Elsevier Press and the Institute for the Study of Labor (IZA). Beginning 2006, the RLE series extends to two volumes per year. One volume will remain in the tradition of the series, consisting of empirical and theoretical contributions in labor economics, while the other volume will focus on specific policy questions. IZA has become one of the largest organizations of labor scholars worldwide while RLE is now a well-established publication containing labor economics research. We hope this new association will be a meaningful development for both IZA fellows and RLE readers.

The first volume of this new editorial partnership focuses on a policy-oriented research avenue concerning tax-benefit systems in Europe. The volume examines the tax-benefit micro-simulation model EUROMOD and its multiple uses. Micro-simulation models are computer-based tools used to simulate most of the direct tax and benefit instruments which affect household budget constraints. They are designed to substantially increase the level of realism in microeconomic models. Moreover, they are linked to household micro-datasets, representative of a national population, so that tax-benefit calculations can be repeated for all the sample households and aggregated. With these computations, it becomes possible to evaluate how existing tax and benefit policies alter inequality, poverty and the overall income distribution. In addition, the simulation of budget constraints and financial incentives considerably improves the econometric estimations of labor supply behavior, fertility choices and marital decisions, thereby allowing better prediction to policy changes.

Although several micro-simulation calculators have been used for many years at a national level (e.g. TAXBEN and POLIMOD in the UK, SYSIFF, INES, MYRIAD and others in France, etc.), EUROMOD goes one step further by simulating tax-benefit systems of all EU-15 countries via an integrated and truly comparative methodology. This calculator has been designed to conduct international comparisons based on homogenized data-sets and harmonized definitions of tax-benefit instruments, making it
possible to address the relevance of tax-benefit policies in a given institutional environment. In particular, EUROMOD allows one to assess the effect of a common reform in particular institutional settings as well as the transmission of a tax-benefit system from one country to another. This was the early motivation of the instrumental paper of Tony Atkinson, Francois Bourguignon and Pierre-Andre Chiappori: "What Do We Learn About Tax Reform from International Comparisons? France and Britain" (European Economic Review, 1988, pp. 343-351). Following the line of research, the present volume provides interesting examples of counterfactual or hypothetical policy changes aimed to assist in designing actual policy and to answer such questions as: Could the British tax credit be fruitfully exported to continental Europe in order to encourage female employment? Are child benefits a necessary move to tackle child poverty in southern Europe? And, how do results differ if the same standard pension reform is implemented in different countries?

While the first prototypes of comparative micro-simulation models were initiated in the early 1990s on a subset of countries (France, Italy and UK), the comprehensive EU-15 model has only been operational for a few years. Its construction took 10 years and two large EU-funded projects (the first one christened EUROMOD and the second known as MICRESA). This long-term effort has been necessary to overcome numerous technical difficulties and to produce a truly flexible and integrated structure. Along the way, this project has been an interesting example of a complex coordination process for 15 European countries and more than 18 different institutions. The model was officially released in 2004 and the number of papers making use of EUROMOD has flourished since then. Various contributions have explored several applications regarding tax policy analysis. They improved our understanding of fiscal and social policies, labor markets and labor market policies, wage setting mechanisms, income distribution and many other issues. This volume attempts to give an overview of these contributions and provide a selection of comparative policy analyses using EUROMOD.

In the first chapter A Short Introduction to EUROMOD: An Integrated European Tax-Benefit Model, Christine Lietz and Daniela Mantovani establish a detailed description of the history of the EUROMOD project, its goals, achievements, limitations and future developments. This chapter also describes how EUROMOD may address various economic questions and policy issues. The authors illustrate how economists in labor, public and family economics can adopt the model and use it for their own research.

With the anticipated decline in the ratio of workers to pensioners, policy makers have questioned the sustainability of Pay-As-You-Go pension
systems in Europe. Whereas some promote private insurance schemes, other simply suggest modifying the existing arrangements, for example (i) to delay retirement, (ii) to lower replacement rates, (iii) to increase social insurance contributions rates and/or (iv) to introduce or extend minimum (solidarity) pensions. Relatively little is known about the likely distributional impact of these recommendations in the short-run, although it would provide useful insight into the political feasibility of proposed policy changes. In Pension Incomes in the European Union: Policy Reform Strategies in Comparative Perspective, Daniela Mantovani, Fotis Papadopoulos, Holly Sutherland and Panos Tsakloglou attempt to fill the gap by presenting original simulations of reforms of the type (ii), (iii) and (iv) along with various combinations. In each case, they identify potential winners/losers and the degree of redistribution across generations; they also evaluate the cost of the reform and its impact on relative poverty. They focus on four ED countries selected on the basis of the diversity of their pension systems (Denmark, Germany, Italy and the UK). The consequences of existing differences in institutional arrangements in particular societies are better understood thanks to the simulation of common reforms in the four countries. In particular, the introduction of a generous minimum pension considerably reduces old-age poverty in all countries but the appropriate means to finance it diverge. For instance, the large dispersion of income among German pensioners makes it possible to reach revenue neutrality in part by income redistribution within this population; in Denmark, the current flat pension system, and the concentration of pensioners' incomes, leaves little room for intra-pensioner redistribution and requires increasing the tax burden of the non-elderly to finance the reform. This exercise helps define nationally appropriate directions for reform.

While the previous chapter examines the effect of contributory pensions and non-contributory benefits (e.g. minimum pensions) on the relative position of pensioners, Gerlinde Verbist focuses on the tax side of the system in The Distribution Effects of Taxes on Pensions and Unemployment Benefits in the EU-15. Specifically, she investigates how the situation of pensioners and unemployed workers is affected by the specific tax treatment of replacement incomes. She observes that despite important heterogeneity across national systems, replacement incomes are less taxed than earnings in all EU-15 countries due to progressivity of tax schedules (and the fact that replacement incomes are lower on average), special provisions in personal income tax systems (e.g. tax allowances and tax credits) and lower levels of social insurance contributions. Consequently, the relative income position of both the elderly and the unemployed is better after payment of taxes and
contributions, especially at the bottom of the distribution. Verbist discusses the implications in terms of redistribution within and between generations.

In *Family Transfers and Child Poverty in Greece, Italy, Spain and Portugal*, Manos Matsaganis, Cathal O'Donoghue, Horacio Levy, Manuela Coromaldi, Magda Mercader-Prats, Carlos Farinha Rodrigues, Stefano Toso and Panos Tsakloglou examine the limited role of family policies in southern Europe and the potential need for more generous schemes to tackle child poverty. The chapter advances previous work on how the family rather than the state can support individuals in need. The authors also explore the scope for policy reform by simulating several types of universal child benefits, which entail a revenue-neutral reform and several schemes in force in the UK, Denmark and Sweden. On the one hand, they find that current expenditure on family transfers in southern Europe is too low to significantly reduce poverty through a simple reallocation of public spending alone. On the other, the Danish scheme would be the costliest, but it would also have the most substantial impact on child poverty in almost all examined countries. Nonetheless, results are mixed across countries; in the Italian case, the replacement of current relatively well-targeted policies by some of the suggested universal benefits could even increase child poverty.

In *Assessing the Impact of Tax-Transfer Policy Changes on Poverty: Methodological Issues and Some European Evidence*, Tim Callan and John Walsh suggest a method to systematically assess the direct impact of tax and transfer policy changes on income distribution. The usual counterfactual -the situation where no change in tax, social security contributions and social benefits has taken place - is useful to keep track of the changes in government expenditures and tax revenues. Yet, it is not a satisfying benchmark against which to assess the distributional impact of policies actually implemented. Instead, the authors suggest a 'distributionally neutral' scenario approximated by indexation of tax and welfare parameters (i.e. tax allowances, tax credits, tax bands and welfare payment rates) in line with wage growth. This benchmark provides a more accurate picture of the impact of policy changes on inequality and relative income poverty. An initial application of the method suggests that over the 1998-2001 period, tax/transfer policy changes in Austria, Greece, Ireland, Portugal and the UK were particularly favorable to lower incomes.

In *Fiscal Drag: An Automatic Stabiliser?*, Herwig Immervoll investigates the effect of taxes at the macro level and revisits the 'automatic stabilizer' argument when accounting for the true complexity of tax schemes and the heterogeneity of tax payers. Taxes are often thought of as automatic stabilizers. In this case, inflation may reduce the real value of nominally fixed
tax band limits, deductions and tax credits, thereby leading to higher real tax burdens, lower consumption and lower aggregate demand. On the other hand, higher tax burdens may lead to upwards pressure on wages and hence a cost-push upwards pressure on prices. Immervoll uses EUROMOD to derive distributions of inflation-induced changes of effective tax rates for representative samples of the population of five European countries. The effect of higher tax burdens on the cost of production is taken into account by simulating changes in the marginal and average tax burdens of employees and by using elasticities from the literature. The results suggest that inflation, combined with an un-indexed tax-benefit system, can produce a moderate upward pressure on wages.

In *Beans for Breakfast? How Exportable is the British Workfare Model?*, Kristian Orsini and Olivier Bargain study the British working family tax credit (WFTC) and the potential effect of this policy when exported into other institutional settings. In the UK, the tax credit was introduced to redistribute income to working poor families, while at the same time to encourage labor force participation of inactive households. In continental Europe, such policy is the subject of numerous debates and is envisaged as a possible instrument to combat the disincentive effect of generous social assistance schemes. In effect, such in-work transfers would recreate a significant financial gap between inactivity and low-paid work, thereby encouraging participation of households living on welfare. To bring further insight into this question, Orsini and Bargain simulate the WFTC for France, Germany and Finland. Typically in these three countries, the generous social assistance schemes are suspected of creating inactivity traps. The authors analyze the impact of this policy measure on poverty rates, on the distribution of effective marginal tax rates (an indication of the potential effect on working hours) and on financial gains to work (an indication of the potential effect on participation). The redistributive impact toward low-earning families may be substantial. On the other hand, the reform is likely to discourage the employment of secondary earners due to the fact that the WFTC is means-tested on joint income of spouses. In particular, this instrument does not seem appropriate in countries like France, already characterized by high effective marginal tax rates on secondary earners due to joint income taxation.

Finally, in *Effective Marginal Tax Rates and Revealed Social Preferences in Spain*, Amedeo Spadaro suggests an original use of micro-simulation models for the normative analysis of existing tax-benefit systems. EURO-MOD allows simulating the distribution of effective marginal tax rates (EMTRs) by numerical derivation of the budget constraint of each
household at the observed levels of earnings. In the fiction of an optimizing social planner, these EMTRs can be thought of as revealing the national level of aversion to inequality, given a certain distribution of labor supply elasticities and wage rates. Then, under simplifying hypotheses and some regularity conditions, the author inverts Mirrlees' optimal taxation model to retrieve social preferences consistent with actual EMTRs. In other words, it is possible to retrieve the level of social inequality aversion for which optimal tax rates coincide with actual ones, as derived by micro-simulation. The approach is applied to Spanish data and shows how social aversion to inequality has evolved with the change in political majority following the 1999 election.

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NOTES

1. For more information on the project and its outcomes, see http://www.iser.essex.ac.uk/raus/emod/.

2. Two new EU-funded projects have started in 2005 and 2006 to extend the scope and capacity of EUROMOD. As well as laying the technical basis for a 25-country comparative research infrastructure, the Improving the Capacity and Usability of EUROMOD (I-CUE) project will begin to involve researchers, data providers and institutions from the 10 new member states in the long-standing EUROMOD collaboration. Together with design up-grades (e.g. a tool to guide the user through the model) and greater clarity in presenting the knowledge base embodied in the model (e.g. a menu of classification systems for taxes and benefits) these developments will prepare for a planned new phase of extending access to EUROMOD to the EU25 social science research community at large. The second project, Accurate Income Measurement for the Assessment of Public Policies (ATM-AP), is a program of three interlinked activities aiming to improve the comparability, scope and applicability of tools, methods and data for the measurement of income and the analysis of the effects of policies on inequality, poverty and social inclusion. It includes the
distributional effects of non-cash incomes and the implementation of a more comprehensive income definition; the implications of (and methods to account for) errors in targeting social benefits, tax evasion and measurement error in income data; the incorporation of the effects of indirect, as well as direct taxes and social benefits in redistribution analysis. Each project will develop methodologies within a cross-national perspective and the resulting method enhancements will be made generally accessible and re-useable by implementing them within EUROMOD.

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