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**IS THERE ROOM
FOR MANOEUVRE IN
FINNISH ECONOMIC
POLICY?**

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Abstract: The Finnish economy has experienced an incredible shock in the first part of the 1990s. The 12 per cent decline in Finland's GDP between 1991 and 1993 led to a sharp rise in unemployment from 3.5 per cent in 1990 to 18 per cent in 1993. The credibility of the Finnish economic policy has improved significantly in 1995 and 1996. The effects of the rapid growth gradually spread to domestic market. Also steps taken to halt the growth in public indebtedness and income agreement reached in autumn 1995 were instrumental in this. The drop in long term interest rate and the substantial narrowing in the interest rate differential over ECU-rate are signs of the improved confidence in the market. The Markka was fixed to ERM in 12 October, 1996. In spite of the promising prospects there are, however, uncertainties attached especially to very high unemployment and high tax rate. The main policy challenges discussed in the report are sustaining the credibility of fiscal policy, continuing structural labour market reforms, stressing the importance of wage-setting from a point of view of unemployment and a need for reduce income taxation for wage and salary earners.

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Tiivistelmä: Suomen talous koki 1990-luvun ensimmäisellä puoliskolla ennennäkemättömän voimakkaan häiriön. Kansantuotteen 12 prosentin supistuminen vuosina 1991-1993 johti työttömyyden ja julkisen velan jyrkkään nousuun. Talouspolitiikan uskottavuus parani merkittävästi vuosina 1995 ja 1996. Viennin nopean kasvun hedelmät levisivät vähitellen kotimarkkinoille. Luottamuksen paranemisen keskeisinä edellytyksinä olivat toimenpiteet julkisen velan kasvun katkaisemiseksi sekä vuoden 1998 tammikuulle ulottuva maltillinen palkkasopimus. Näiden seurauksena pitkät korot laskivat voimakkaasti ja korkoero ECU-korkoon supistui merkittävästi. Ongelmana on korkean työttömyyden luoma epävarmuus sekä tyytymättömyys palkansaajien tuloveron korkeaan tasoon. Talousneuvostolle laaditun raportin (29.2.1996) mukaan 1990-luvun loppuvuosien keskeisimmät talouspolitiikan haasteet ovat finanssipolitiikan uskottavuuden ylläpitäminen, työmarkkinoiden rakenteellisten uudistusten jatkaminen, palkkapolitiikan saattaminen pysyvästi työllisyyttä tukevaksi sekä tarve alentaa palkansaajien tuloverotusta.

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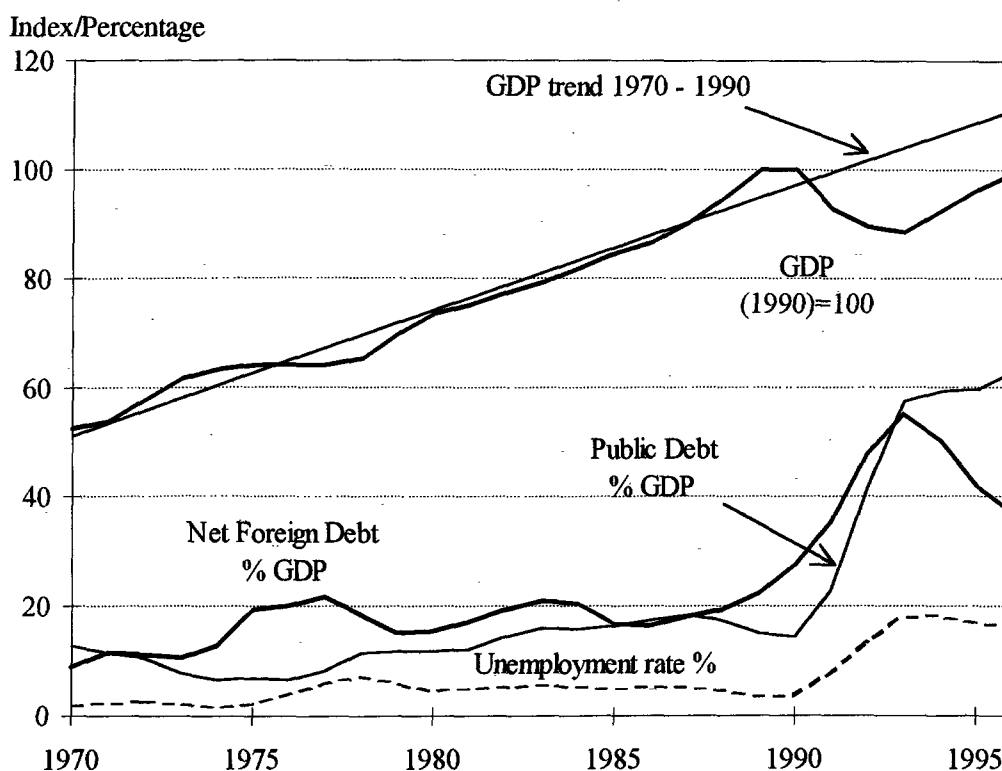
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1 Situation at the end of 1996 has become more clear

The 12 per cent decline in Finland's GDP between 1991 and 1993 led to a fall-off in demand for labour and a sharp rise in unemployment (Figure 1). The drop in production increased in unemployment especially in labour intensive sectors which caused a marked rise in public expenditure and a reduction in tax receipts. The ratio of gross public debt to GDP, which in 1990 stood at 17 per cent, had risen to 60 per cent by 1993, more than 3½-fold.

For a long time the fundamental question in economic policy was how to bring down unemployment without at the same time compromising the goal of stabilizing the public sector and the accompanying credibility of the economic policy line.

Figure 1 GDP, net foreign debt, public debt and unemployment in Finland, 1970-96



The credibility of the Finnish economic policy has improved significantly in 1995 and 1996. The effects of the rapid export growth gradually spread to domestic market. Also steps taken to halt the growth in public indebtedness and the incomes agreement reached in autumn 1995 were instrumental in this. The drop in long term interest rates and the narrowing in the interest rate differential over Germany by more than two percentage points between the early of 1995 and late 1996 are signs of the improved confidence in the market. Even though the improved credibility of economic policy has reduced nominal long-term interest rates, in an environment of

low inflation real rates have remained high. In the third quarter of 1996 real five-year interest rate was more than five per cent.

At the end of 1996 Finland's economic progress was on a firmer base than in early months of the year. Factors contributing to the better prospects include:

- Economic growth is recovering in Europe
- Exports are recovering from the downswing
- Current account surplus has been resilient despite some deterioration of the terms of trade
- Robust growth of private consumption
- Growth of investment to continue
- Output growth to strengthen
- Inflation subdued
- Stable financial markets
- Central government deficit is in decline and debt grows substantially more slowly.

Also the uncertainty surrounding the third stage of EMU has declined in the last few months. The Markka joining to ERM in 12 October, 1996 has given extra credibility for the Finnish economic policy line.

In spite of these promising prospects there are, however, uncertainties attached especially to very high unemployment and high personal income tax rate and the disagreement over the need of structural reforms in the labour market.

When analysing the Finnish economy it is vital to emphasize, that although unemployment is the result of the reduced demand for labour caused by the decline in production, the growth in long-term unemployment is rapidly altering the structure of unemployment. Structural factors in the labour markets and the policies influencing these will be of significant importance in the future. Further-more structural reforms of the labour markets, such as measures to do with unemployment benefit, income traps and labour market flexibility, will foster the way for more active fiscal and monetary policy. Thus, macropolicies and structural reforms are closely interlinked.

The actions already taken in economic policy, such as the public sector consolidation, reduced interest rates, the employment programme adopted in autumn 1995, tax cuts and the wage agreement have begun to work in the private sector's demand. In order to increase credibility in the economy, the improved balance in the economy that has been won with much sweat and blood has to be carried on. Changes in the overall line of policy or doubts would increase uncertainty and have harmful effects on growth.

2 Limited room for manoeuvre in fiscal policy

A central and very problematic question in fiscal policy is whether to stick to the policies designed to bring down indebtedness or whether to calculate that reducing taxes or increasing spending would produce better results, at the risk of increasing indebtedness. Of course the same pattern of indebtedness can be attained at various levels of public spending and taxation, as has been emphasized recently. This represents another fundamental question determining fiscal policy.

From the point of view of growth, the aim of fiscal policy is to create stability and, by public spending and taxation support economic growth. From the perspective of long-term growth, the fundamental issue is to increase productivity, primarily by investing in the quality of human capital. As well as education, this also means battling against long-term unemployment by improving the productivity promoting effects of learning by doing. Economic stability, the proper functioning of the labour markets, incentives to reward labour activity, risk-taking, entrepreneurship and saving, and care for the basic health of the economy are all key factors affecting long-run economic growth that rest with the authorities.

Both in terms of the ability to pay salaries and increase employment, rapid growth has been observed in sectors creating new products using innovative techniques and applying new production methods. The authorities also have an important role in providing the conditions for innovation. In Finland, the framework for innovation has improved markedly in the last 10-15 years. Nonetheless, taken measures to stimulate growth in research and development spending and investment in training demand time to be thoroughly implemented.

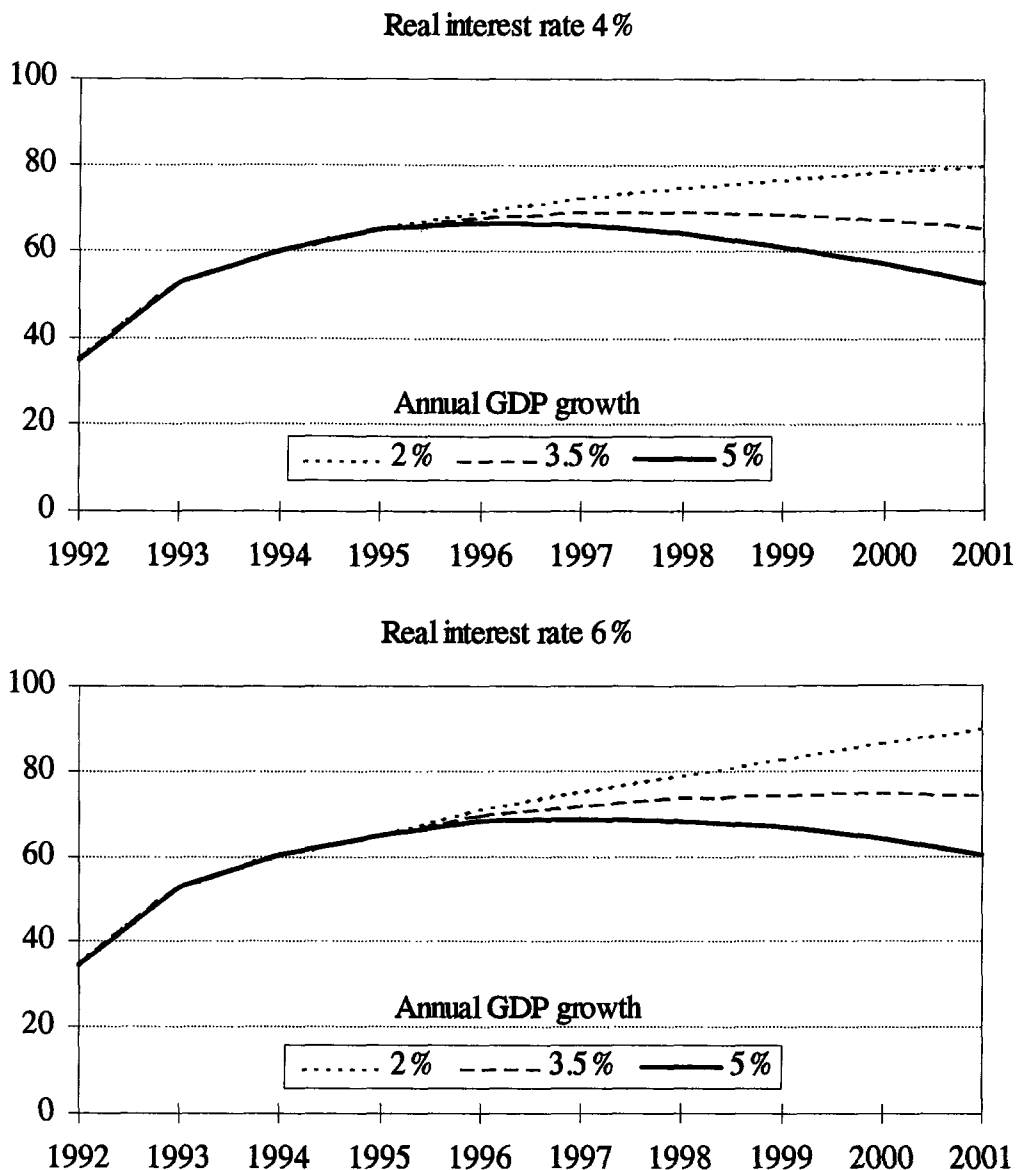
By allowing indebtedness to grow it is believed that the increased debt will revive demand in the private sector and plug the loss of production caused by the decrease in GDP. Experience both in Finland and in other countries shows that it is difficult to restrain indebtedness. It is extremely sensitive to fluctuations in taxation and spending, GDP growth and increased risk premium on real interest rates (Figure 2). In many OECD countries, including Finland, debt as a percentage of GDP has consistently overshot target.

The control of public debt, in practice state debt, is essential to maintain credibility in economic policy. Arguments for bringing about a rapid halt in indebtedness include the following:

- Control of debt offers the possibility to participate in the third stage of EMU.
- It is important to bring debt under control at a time when interest expenditure is still bearable. If Finnish state debt as a ratio of GDP were at the level of Belgium, interest expenditure would amount to FIM 60 billion, almost one third of state spending. In such a situation interest expenditure would have a significant crowding out effect.

- For the present the pressure on spending caused by the ageing of the population is low, but in 10 - 15 years there will be a sharp rise in pension, care and health spending resulting from rapid population ageing.
- Downward pressure on tax rates caused by international tax competition will increase as integration progresses. In addition to excise duties, remote Finland must also reduce especially personal taxes.
- Increasing debt does little to plug losses in production.
- Passing solution of the debt problem on to coming generations is nothing short of irresponsible.

Figure 2 Ratio of gross state debt to GDP under different scenarios



Fiscal policy in the coming years is constrained by decisions taken on total state spending up to 1999 based on the target of balancing the state finances. Temporary fluctuations in growth should not be allowed to influence too easily the long-run aim of debt control.

Recent economic policy debate has brought calls for economic stimulus through lower taxes. What would be the effects of lower taxation? If a relatively quick halt to the growth in indebtedness is to be achieved, can we rely on tax cuts paying for themselves in the form of stronger growth or will they have to be paid for in further cuts in spending. What would be the impact of such a situation?

Research by the working group of the Economic Council of Finland and international evidence show that policies designed to stimulate the economy may be ineffective or even work against themselves in cases where public debt is growing rapidly, or stays at a high level, or where the debt problem is of a permanent nature or there is widespread uncertainty about the ability to control indebtedness.

In times when control over public debt is weak, these adverse effects may be caused by changes in interest rates and income expectations. Policies that increase the public deficit and indebtedness may lead to a rise in interest rates if creditors suspect the borrower's exchange rate stability. An increase in the tax burden coupled with higher interest rates may also induce households to scale back their income expectations and lead to decreased consumption and increased saving.

Although the effects of fiscal policy are dependent on many other factors, the Finnish economy appears to have found itself in just such a predicament in recent years. Record deficits have not increased total demand as balanced finances would have done. The restoration of the Finnish economy is now on much more firmer footing than some years ago. The caution in reducing taxation in the short run is needed although there is increased room for manoeuvre in that respect. The Government reduced in the budget proposal of 1997 the household income taxation by 5 billion, which was financed by increased energy taxation (1 bil.), by cutting subsidies to the local government (2 1/2 bil.), unemployment benefits (1/2 bil.), subsidies for the business sector (1/2 bil.) and some other expenditure cuts (1/2 bil.).

The following example might serve to illustrate the choice facing fiscal policy in the future years. For personal income tax reductions to have any impact, they should be significant, say FIM 10 billion in 1998 and 1999. It has been estimated that even under favourable circumstances the dynamic effects of tax cuts only pay for themselves up to 50 per cent. In situations such as that of Finnish economic policy at the present, the self-financing effect of tax cuts could be about FIM 5 billion. The remaining 5 billion would have to be financed by additional spending cuts or by increasing other taxes.

A substantial proportion of any tax cuts could be channelled to higher saving if consumers build expectations of tax increases into their future plans. In this way the positive consumption-boosting effect would be small. This is supported by experiences in recent years in Finland. The growth in purchasing power provided by two tax refunds was partly channelled into saving. In 1998 when consumer confidence is estimated to be much more better than in 1996 the additional incomes given by tax cuts, are not saved in a great extent.

If at least half of any tax reductions are funded by cuts in spending, this could have an immediate consumption-reducing effect. This would be greater the more such cuts are directed at low earners. All in all such a programme should be carefully tailored so that it would not increase indebtedness and lead to higher interest rates. Thus a short-term benefit of tax reductions at least partly funded by spending cuts could be quite small. It would be advisable to use changes in taxation for supporting moderate income settlements in 1998 and 1999.

Room for manoeuvre should be considered looking a public sector as a whole. If local governments in a somewhat better times are using the increased revenues by raising expenditure, there are very limited possibilities to cut taxes.

Clearly the tax wedge and international competition in taxation mean that the relatively high level of income taxation in Finland should be reduced. Wage earners' income taxation affects long-term growth also in the form of incentives. Any room for cutting taxation ought to be used to reduce the labour taxation. Reductions in employment taxation should also be brought about by structural changes, for example by grading social security charges. This could be difficult technically, but with modern data processing techniques it ought to be possible to grade charges, at least those due to the state.

Tax cuts in 1997 would not affect labour costs because the wage agreements affecting that year have already been made, but they would improve the negotiating climate for the wage agreements in 1998-1999. When the growth prospects are rather promising for 1998 and 1999, it will be easier to retain credibility in the debt target in the medium term and there will not be need to make substantial additional savings after cutting personal income taxation. However it have to be careful not to boost domestic demand by tax cutting so that external balance will be deteriorated. The danger of the overheated economy is diminished by huge amount of unused labour resources and structural labour market reforms implemented in next future years.

3 Structural labour market reforms needed

Because of the limited room for manoeuvre in macro policy and the uncertain factors present, attention has focused on structural reforms of the labour market.

The key issue is how to reduce tax wedge and reform working life so that growth results in improved employment.

The Finnish economic environment, the nearness of the Baltic States, will mean pressure to keep permanently good price competitiveness. Especially the industries of the low labour costs will easily transfer their activities to the Baltic States.

The main reason for the present unemployment is the fall-off in demand for labour caused by the contraction in GDP and the allocation of demand against labour intensive sectors at the beginning of the 1990s. The rise in long-term unemployment is altering the structure of unemployment. According to the traditional classification, unemployment is caused by both structural factors and the level of economic activity. If unemployment is entirely structural, a rise in total demand does not raise demand for labour but increases wages and salaries, leading before long to higher inflation. But if unemployment is considered to result from a lack of demand, stimulating demand by counter-cyclical policies increases demand for labour and reduces unemployment without wage rises posing a threat to employment and inflation.

In practice, dividing unemployment into cyclical and structural parts is very difficult and in the transitional state that Finland is now in one might question whether it is at all possible to accurately gauge the equilibrium state of unemployment and hence the level of structural unemployment.

Structural unemployment can be represented by various measures, which can give differing results. The OECD uses the non-accelerating-inflation rate of unemployment (NAIRU) index. Because of its calculation method, structural unemployment as measured by the NAIRU convention is consistent with true unemployment. According to the latest estimates¹ the NAIRU estimate in Finland in the middle of 1990's is 12 per cent.

Another way to define structural unemployment is based on the so-called Beveridge curve, a UV curve from which the level of structural unemployment is calculated. If the structural problems of the labour markets deteriorate, this is seen in the UV curve shifting away from its origin (Figure 3).

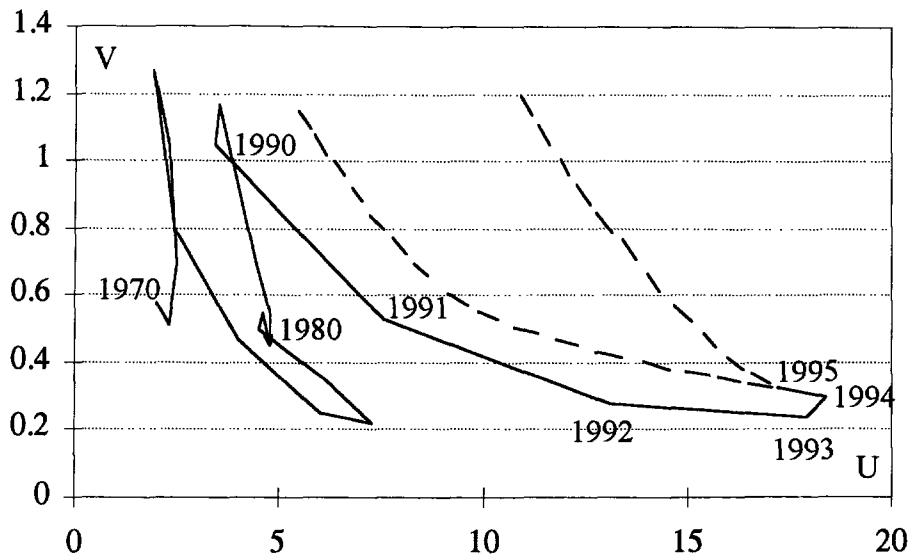
But interpretation of the UV curve is also problematic since it shows a negative correlation between the stocks of unemployed persons and vacancies in the equilibrium state. Structural changes cannot be differentiated from changes in demand on the basis of labour market resources alone. A shift in the UV curve could be caused by job-seekers changing their search activity because of changes in unemployment benefits. That would be an example of a structural change. But a

¹ Holm, Pasi and Somervuori, Elina: Structural Unemployment in Finland, paper presented to OECD, October 7, 1996.

curve shift could also be caused by an increase in layoffs in a cyclical downturn (unemployment inflow) or by a decrease in recruitment (unemployment outflow).

It is difficult to assess the likely shift in the Beveridge curve in the late 1990s. Figure 3 depicts two qualitative scenarios. If it is assumed that the structure and functioning of the labour market do not change fundamentally, the Beveridge curve could be close to the curve for 1990 - 1993. Then if there were around 15,000 vacancies (0.6% vacancy rate), which is a long-run average, the unemployment rate could be under 10 per cent. But if we assume that the structure and functioning of the labour markets in the latter half of the 1990s keep the employment market inflexible, the Beveridge curve for the late 1990s could differ radically from the origin. Then an average number of vacancies (15,000) could be accompanied by an unemployment rate of around 15 per cent.

Figure 3 UV curve for Finland, 1970-95
(V = vacancies/labour force, U = unemployment rate, %)

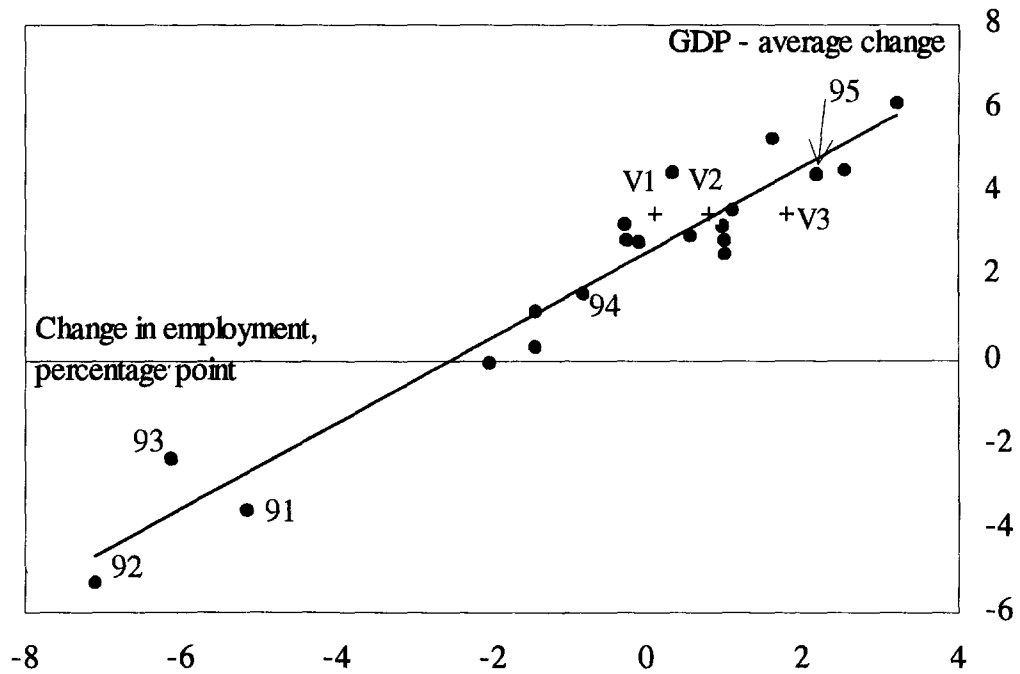


The interdependence between GDP and unemployment is traditionally illustrated by means of the so-called Okun's law, according to which there is a relatively consistent correlation between changes in GDP and changes in unemployment. The correlation between growth and employment/unemployment has been very consistent between 1976 and 1995 (Figures 4 and 5). In 1994 and 1995, for example, the correlation was in line with the model. Growth of 2½ per cent has been needed to improve employment, while for unemployment to come down three per cent growth has been required. The difference in the figures results from an increase in the labour force. The fact that unemployment has not significantly decreased even after the recession is attributable to insufficient growth, the rise in labour costs and the increase in the labour supply. The violent swings in the number of vacancies within a few years shows that companies have an uncertain perception of the demand picture.

The correlation between growth and employment/unemployment is somewhat higher in Finland than in most EU-countries. The pressure to improve productivity has been in Finland in history higher than in competitive countries partly because of high nominal and real wage demand.

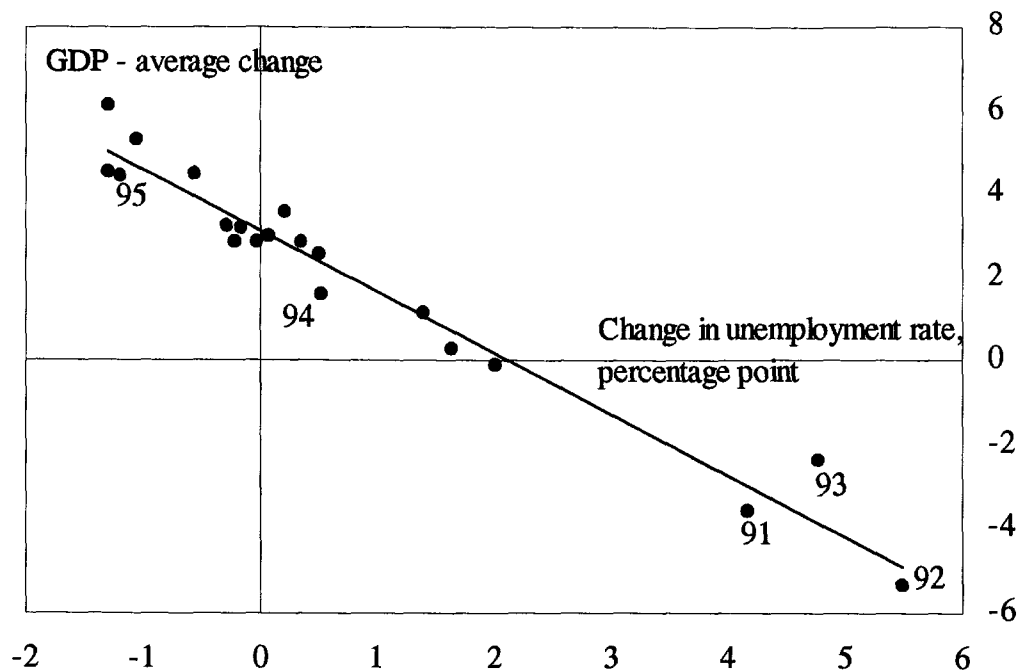
The effects of structural labour market reforms on employment are hard to predict and frequently contradictory. For example, flexible working hours can have the immediate effect of reducing the need for new labour, but by improving capacity utilization improve corporate earnings and thereby support employment. Temporary contracts reduce the employer's risk and make it easier to hire staff. On the other hand they increase employees' uncertainty and undermine commitment to the company's targets. But there is no reason to delay structural reforms that improve the functioning of the labour markets, because there are many structural rigidities in the Finnish labour market and because structural reforms will reduce the equilibrium unemployment rate and open the way for more actively demand-orientated economic policy.

Figure 4 The correlation between growth and employment¹, 1976-95



¹. Alternative scenarios V1, V2 and V3, see page 14

Figure 5 The correlation between growth and unemployment, 1976-95



In the coming years it should be stressed the following three structural changes where we could make progress in Finland. First of all, the room for manoeuvre in taxation ought to be used to reduce the tax wedge in income taxation mainly for low

income groups. Secondly, flexible working hours would improve capacity utilization and economic growth and would also improve employment.

The third structural reform concerns unemployment benefit, which has become more generous from the middle of the 1980s. Income-related unemployment benefit, which under the reform introduced at the beginning of 1985 gradually decreased with lengthening unemployment spell, was made almost automatic under the reform introduced in 1991. Under this, before 500 days of unemployment are up, an employment spell of six months provides entitlement to a further 500 days of allowances at the original level. In 1992, however, the income-related proportion of benefits was reduced from 45 to 42 per cent. Nonetheless, unemployment benefit in its present form breeds passivity. The introduction of more active measures into unemployment benefit would improve economic growth. At the same time the burden on the public purse and the moral hazard problem could be alleviated.

Issues related to statutory working conditions are linked to the whole future of the collective bargaining system. Can reforms be introduced with the present system, or should there be local contracts? If the central organizations and trade unions cannot agree on this, the result will be a spread of local contracting. In the current situation radical structural labour market reforms, such as loosening the protection against dismissal, removing the universal validity of collective agreements or unrestricted increases in the number of temporary employment relationships, could even have a negative effect on employment by increasing the general uncertainty in the economy.

When introducing flexible arrangements, or for that matter any form of structural labour market reforms, it is important to ensure that they do not entrench a division into those with secure employment and workers in a far weaker position, that is worsen the insider outsider dichotomy. Finland's labour markets are in European perspectives flexible. But the flexibility applies mostly to new employees. Existing employees have fiercely guarded their interests.

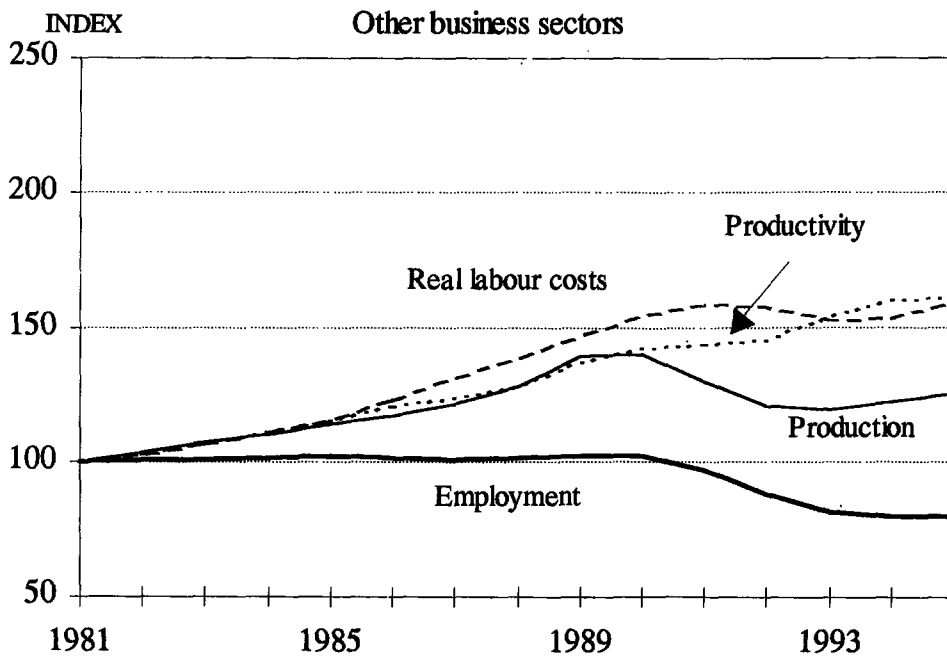
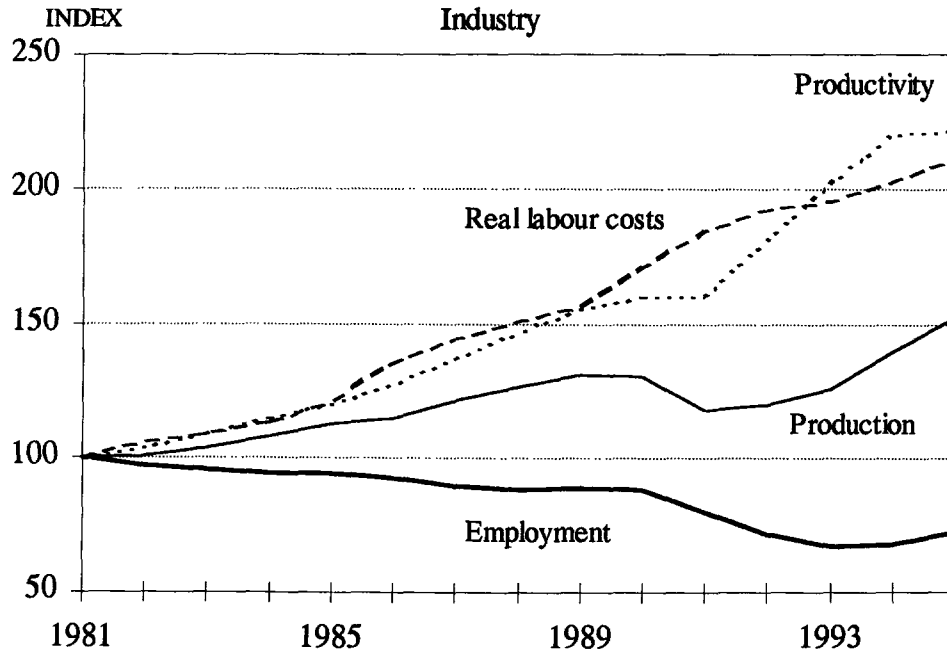
4 Wage-setting crucial

In Finland it has been taken for granted in recent years that wage policy has been very moderate. However, the truth is somewhat different (Figure 6). Unemployment and the state debt have responded to the collapse in production, but not so much the wages and salaries of those still in work. Real labour costs have risen quite considerably during the recession. In industry labour costs and productivity rose fairly consistently until the end of the 1980s. In 1990 -1991 the rise in labour costs exceeded the growth in productivity and at the same time production shrank. Companies slashed their payrolls. Now that production has been climbing briskly, productivity has also risen exceptionally fast.

In other business sectors, the growth in real labour costs began to exceed the growth in productivity from the middle of the 1980s. When domestic demand collapsed at

the turn of the decade, the drop in both production and employment was dramatic. Although the growth in real labour costs was halted and even brought down and productivity improved, which helped the adjustment process, employment in other business sectors has only recently started to grow.

Figure 6 Production, employment, productivity and real labour costs in industry and other business sectors 1981-95



Apart from salary increases, the growth in real labour costs has resulted from an extension of the tax wedge, largely through rises in the charges funding pension and social security expenses, especially financing of unemployment benefits.

The working group of the Economic Council of Finland calculated the prospects for employment up to the year 2001 based on three alternative scenarios. In assessing the demand for labour, equations were estimated on the basis of material for the business sectors for the years 1970 - 1993, in which changes in employment are dependent on changes in the real labour costs and on the growth in production in the sector. Price and activity elasticities of labour demand are measured by long-run elasticity, which chiefly represents the situation in the 1970s and 1980s. In some sectors (e.g. banking and construction) there may have been or may still be such radical changes occurring that the received text-book explanation of employment does not necessarily apply. The equations do not include any other inputs, although the direction of real labour costs does define their relative price trend. This premise, which is based on partial equilibrium and constrains interpretation of the results, should be borne in mind when interpreting the trend in labour demand suggested by the equations.

The assumptions concerning real labour costs in the three scenarios plotting the effect of labour costs on the future employment trend vary, but in all the computations production is assumed to grow at the same rate. The production growth forecasts by sector are based on the latest available long-run estimates, which show GDP growing at a 3½ annual rate.

The trend of labour costs in 1996 - 1997 is largely known because the current collective agreements extend until the beginning of 1998. In some sectors labour costs will rise this year by 2½ - 4 per cent because of wage claims, salary sliding and structural changes. In 1997 they will probably rise somewhat less. With only small rises in producer prices, real labour costs are rising at around two per cent a year.

The first computation uses the actual trend in labour costs in recent decades. The rise in real labour costs in each sector reflects the average rise in 1970 - 1993. In the second alternative real labour costs continue to rise for the next few years at the estimated approximate two per cent annual rate. The third scenario is based on a very moderate appreciation in labour costs. In this alternative there is hardly any rise in real labour costs.

The first scenario, which could be called a "continuation of the old ways", culminates in very weak employment situation. The rise in labour costs would force companies to improve efficiency and employment would lose out. In scenario 1 output growth of around 3½ per cent would not decrease unemployment, since public welfare services will not increase their workforce as they did in the 1970s and 1980s. In turn, growth in real labour costs will prevent employment increasing in

private services and other sectors just as before. Under such conditions, the benefits of relatively favourable economic growth would accrue mainly as rapid earnings growth to those already in work. By 2001 unemployment would still be stubbornly at the 1995 rate of 17½ per cent.

Table 1 The labour market prospects in 1995 and 2001, thousands of persons

	1995	Alternative scenarios, 2001		
		1	2	3
Labour supply	2 497	2 520	2 540	2 550
Labour demand	2 067	2 076	2 174	2 304
Number of unemployed	430	444	366	246
Unemployment rate, %	17.2	17.6	14.6	9.6
Real corporate labour costs, average annual change, %	4.0	3.4	1.9	0.2

The second scenario reflects earnings developments in 1996 and 1997 and would also result in a very high unemployment rate of around 14½ per cent by 2001.

For the labour demand forecast projected in scenario 3 to come about, labour productivity growth would have to be slower in relation to production growth than previously. This would be because employers' real labour costs would increase very little, making labour more attractive. The broad picture resembles the development in the US in recent decades. There real earnings have not increased, but a small climb in production has been sufficient to increase employment.

In conclusion we can say that if taxation and wages policies remain the same as in recent decades, economic growth would produce very little in the way of employment. For there to be any significant improvement in employment income tax should be reduced, incremental employment costs cut and surpluses would not have to be squandered in wages and salary rises as before.

5 Conclusion

In the medium term, the outlook for the Finnish economy is rather good except unemployment. If the old ways continue the unemployment rate will remain stubbornly at around 15 per cent. This would maintain the pressure on public expenditure and taxation. In wages policy the variables are salary increases on the one hand and employment on the other, and these need to be clearly borne in mind

in labour market policy setting. Structural labour market reforms are inevitable, although they are not an instant solution in themselves. In the present situation tax measures should be targeted to reduce tax wedge and they should be combined in incomes policy agreements made after the present wage agreement.

