Wealthy Europe vs. Poor Europe

Ways of Dealing with Taxation Among the Rich and Poor Countries of the EU

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Introduction

The years 2004 and 2007 represent very important moments in the history of the European Union. The number of the member states has increased in an unprecedented way, reaching 27, and including for the first time in the european community countries from the former soviet block. Another important step on the road leading to a unified Europe has been accomplished.

Disregarding the euphoria and the perspectives it grants for a future positive development of Europe, the enlargement also brings in new problems and raises important questions. It is not hard to observe that there is a consistent economic gap between the long run EU countries and most of the new member states. What is the manner in which these discrepancies could influence the future of the European Union?

I shall attempt to answer this question concentrating on the issue of EU fiscal policy. There are currently important differences between the taxation systems of the european states. The rich states are having high, progressive tax rates, while the new, poorer countries are implementing more market oriented reforms by adopting lower tax rates systems. Since the EU is a single market this has considerable effects on the mobile capital flow. My research question is What is the manner in which the different ways of dealing with taxation among the rich and poor EU countries can shape the future development of the Union?

The paper will have the following structure. I will begin with a short outlook on the role that the tax system has in the well functioning of a state. Then I will offer some empirical data about the distribution of wealth among the EU and the tax systems of the member states. Next, I will explain what causes the difference between the fiscal policies of the rich and poor countries. Finally I will analyze the opportunity of the two possible scenarios that result from this situation: the implementation of a EU tax harmonization system or the perpetuation of the tax competition current state of affairs.

1. What are taxes good for?

Raising taxes is one of the fundamental functions of any government and probably the most profound expression of its sovereignty. Since the globalization of economy is transforming every day that passes trade and business into an international phenomenon, the ability to collect taxes from the economic agents operating on its territory remains the national state's most important instrument of exerting control on the economic developments within its borders.

Economic theory states that the goods and services which cannot be (or cannot properly be) offered by the free marked must be supported by the government. In order to provide this public goods and services the government naturally needs funds. To get this funds it has to collect taxes. So, citizens pay taxes for the government and get in return access to public goods, like security, education, health, keeping a clean envirolment, social security, etc.

Nontherless, it is not easy to decide which of this goods can be more effectively provided by the state. Depending on the goods and services the government decides it needs to provide it has to settle its taxation policy. As the amount of services the state offers to it's citizens increases, the amount of taxes it has to collect follows the same path.

After the world war two the welfare state system, which refers to the particular situation where the government takes upon itself the task to ensure a decent living standard for every citizens and an equitable distribution of wealth within the society, became a very popular concept in western Europe and many countries implemented this model. So, nowadays many of the long run EU countries have a very high rate of budgetary spending. The budget of the EU-15 states group varies between 35-50% of the GDP. This is very much if we compare it to the budget of the USA, which comprises only 18% of the GDP (Šimović 2007). To be more specific in Germany the budget expenditure rises to 36, 2% of the GDP, while in Sweden it is even higher, going up to 50, 6%. France and Italy also have very high budgetary spending rates, closing 45% of the GDP. However, the stability of this system is threatened by the though fiscal competition these states have to face from the new EU countries.

2. Differences of revenues and fiscal policies among the EU states

The European Union has experienced previous enlargements and has already faced the task of successfully integrating countries with a lower level of income at that moment (like Spain, Portugal, Greece and Ireland). However, none of these precedents can be regarded of a clear pattern for the current development of the EU. Never have so many countries joined the EU in such a short amount of time, almost doubling the member states, from 15 to 27. As you can obviously observe from the following figure, the discrepancies of income between the new and old members of the EU cannot be neglected.

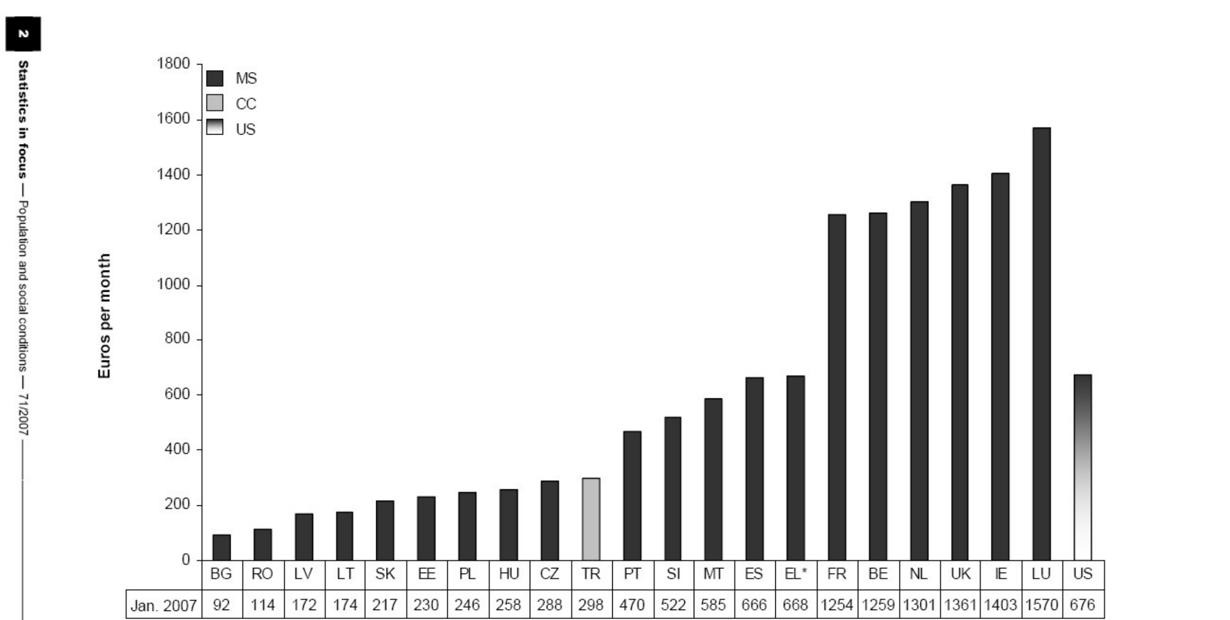


Figure 1: Minimum wages in certain EU Member States (MS), one candidate country (CC) and the USA, January 2007, in euro

** : July 2006 data*
Source : Eurostat, database on minimum wages.

Looking at the level of the minimum wage in euro in January 2007, we can divide the member states into three separate groups (Eurostat News Release 18 June 2007). In the first group Bulgaria (€92 per month), Romania (€114), Latvia (€172), Lithuania (€174), Slovakia (€217), Estonia (€230), Poland (€246), Hungary (€258) and the Czech Republic (€288), where minimum wages were below €300 per month in January 2007. Portugal (€470), Slovenia (€522), Malta (€585), Spain (€666) and Greece (€668 in July 2006) fell into a second group, with minimum wages of between €400 and €700 per month. In France (€1 254), Belgium (€1 259), the Netherlands (€1 301), the United Kingdom (€1 361), Ireland (€1 403) and Luxembourg (€1 570) minimum wages were over €1 200 per month. One can easily observe that the first group is comprised entirely of newly integrated east european states. The economic gap further expands if we are to consider the amount of the population earning the minimum wage in these countries. As we move down on the graph, from the richest to the poorest country, the percentage of the population earning the minimum wage increases.

Now, let us take a look at the taxation policies. The following figure presents the corporate income tax rate currently enabled in the EU countries. Here too, there are considerable discrepancies to be noticed.

Adjusted top statutory tax rate* on corporate income in 2007, %

BG	CY	IE	LV	RO	LT	HU	PL	SK	EE	SI	CZ	EU27**	EL	AT
10.0	10.0	12.5	15.0	16.0	18.0	18.6	19.0	19.0	22.0	23.0	24.0	**24.5**	25.0	25.0

NL	FI	PT	DK	SE	EA13**	LU	UK	ES	BE	FR	MT	IT	DE
25.5	26.0	26.5	28.0	28.0	**28.5**	29.6	30.0	32.5	34.0	34.4	35.0	37.3	38.7

Source: European Commission Services.

* Adjusted top statutory tax rate on corporate income takes into account corporate income tax (CIT) and, if they exist, surcharges, local taxes, or even additional taxes levied on tax bases that are similar but often not identical to the CIT. In order to take these features into account, the simple CIT rate has been adjusted for comparison purposes.

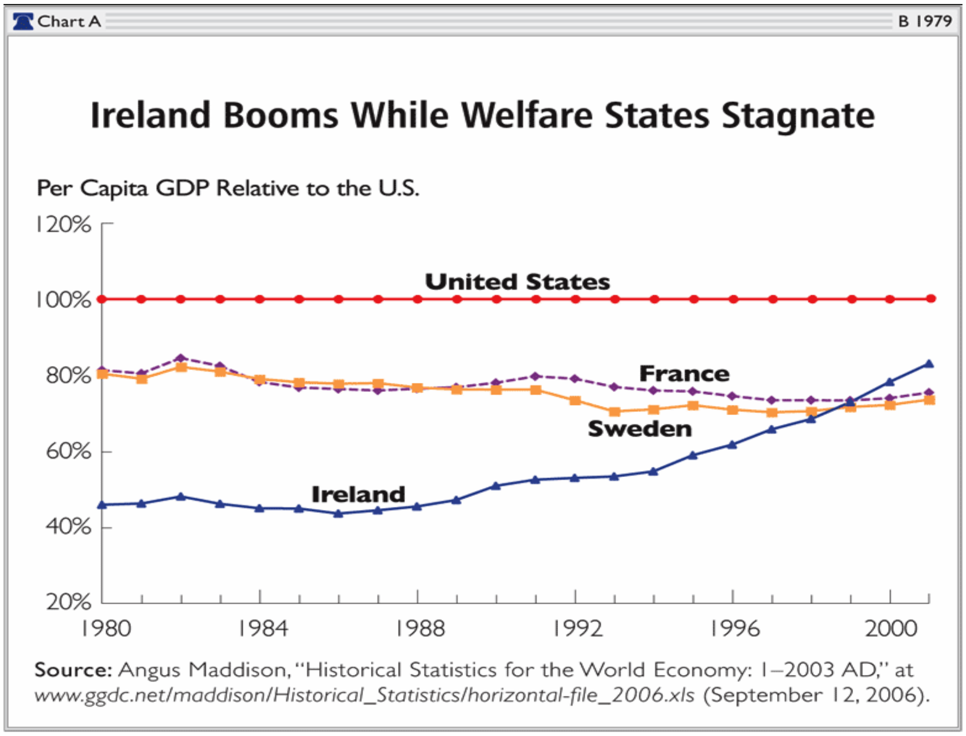
** Arithmetic average.

The countries with the lowest corporate income tax rate are Bulgaria, Cyprus, Ireland, Latvia, Romania, Lithuania and Hungary. All, except Ireland and maybe Cyprus, can be regarded as poor countries, considering the EU standards of living. On the other hand the champions of high taxes are Belgium, France, Malta, Italy and Germany.

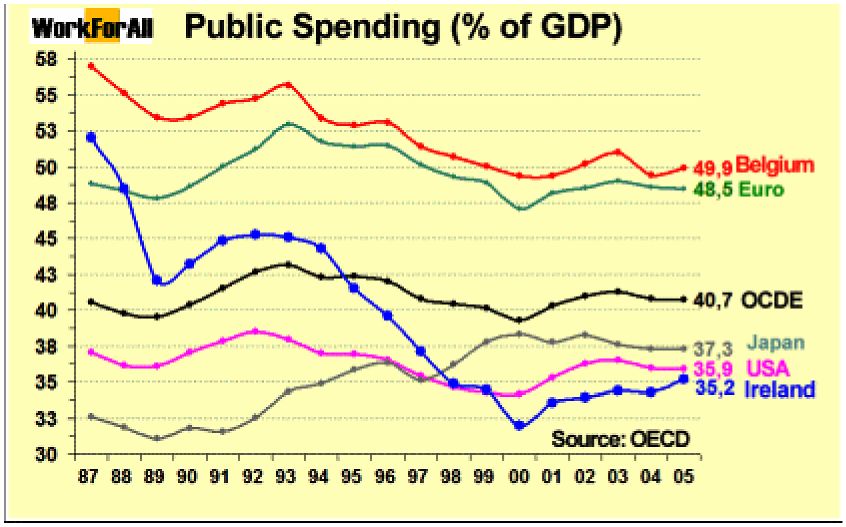
3. What are low taxes good for?

Simple economic theory can demonstrate why a pro-market oriented tax policy is an important incentive for the fast development of business and economic growth, boosting both the foreign investments and the local companies. The lower the tax rate, the higher the marginal profit becomes for an economic agent. This means that the existing companies will have more money available and will be able to invest and extend or improve their activities, thus creating more jobs and overall wealth in the society. A low tax rate will also be an incentive (it must be mentioned that it is not the only one and maybe not even the determinant factor) for foreign companies to locate their activities in such a jurisdiction in order to safeguard their profits. As Robert E. Anderson, a development consultant and former World Bank economist, points in his book *Just Get Out of the Way: How Government Can Help Business in Poor Countries* "The only way to reduce poverty around the globe is to increase the rate of economic growth. The only way to increase the rate of economic growth is for governments to put in place policies and institutions that encourage the private sector to become more efficient and productive…This is how the rich countries achieved high incomes for most of their citizens. I see little reason to believe that today's poor countries will be able to reduce poverty in any other way" (Anderson 2004).

There are many examples for the new EU member states that show how free market reforms generate prosperity. I shall begin with the case of the 1980' reforms of Margaret Thatcher and Ronald Reagan in Great Britain and the US. Both leaders inherited weak economies but managed to restore growth and vitality. The top tax rate was 83 percent when Thatcher took office, and she reduced the top rate to 40 percent. The top tax rate economic in the United States was 70 percent when Reagan was inaugurated, and he lowered the top rate to 28 percent (Mitchell 2005). The situation of previous third world countries like Taiwan, South Korea and Singapore, that managed to evolve in a relatively short period to top class economies is also worth mentioning. But probably the most impressive evidence of how low tax policies can boost the economy is offered by Ireland. Twenty years ago Ireland was what economist Daniel J. Mitchell describes as "an economic basket case with double-digit unemployment and an anemic economy"(Mitchell 2005). It also had a very high tax rates system. The top tax rate on personal income in 1984 was 65 percent, the capital gains taxes reached a maximum of 60 percent, and the corporate tax rate was 50 percent. Through a series of gradual reforms the personal income tax rate is 42 percent, the capital gains tax rate is just 20 percent and the corporate income tax rate is only 12.5 percent. What happened next can be easily observed in the following figure.



Nowadays Ireland has the second highest standard of living outmanoeuvring welfare states like France and Sweden, whose economies have been worryingly stagnating for quite a long period. During 1990s Irelands average growth rate was 7.7%, with unemployemet dropping as well. One can observe in the following graph how the rapid development is correlated with a dramatic decrease in the budgetary spending in the same period.



4. Consequences of the fiscal competition within the EU

Currently the EU fiscal policy is in a situation described by economists as fiscal competition. This means that the sovereignty of the member states concerning taxation policies has been left untouched. Today levying taxes is exclusively in the domain of the EU member states. This means that the states can compete with each other, through their tax systems for attracting foreign investments. So companies are able to reduce tax burdens by shifting capital and/or labor from high-tax jurisdictions to low-tax jurisdictions. The effects of tax competition is emphasized by the fact that investment is more mobile between countries within the EU and non-EU countries.

If these is a clear advantage for the investors and entrepreneurs, since they can take advantage of lower tax rates by doing business in jurisdictions with lower taxes, and for those who engage in reforms regarding the liberalization of their economies, it is clearly a bad omen for the countries with high tax policies.

The east european states are slowly becoming more attractive for the companies to invest there. So many of these multinational firms have already decided to shut down their production facilities in western Europe and move to the new member states, taxation being one of the main reasons. This was also the case of Ireland but since it a small country and a unique case in Europe at that time it did not affect the economies of the other states in a visible manner, though it did caused some scandals in the late 1990s.

This new situation clearly causes important concerns for the high tax countries, as can be seen from the development of the case regarding the recently closing of the NOKIA factory in Bochum, Germany. On the long run there are two options for this category of European countries. Either they reduce the tax rates in order to reboost their economies or they eradicate tax competition by implementing a tax harmonization system at the European level. Germany and France are currently the main advocates of such a measure.

5. Fiscal competition vs. fiscal harmonization

Tax harmonization is used to describe the equalization of corporate income tax rates and the standardization of corporate income tax bases within the EU. More precisely it refers to the establishment of a minimum corporate income tax rate bellow which no EU country will be allowed to lower it's tax rate.

There has been talking about the opportunity of such a system since the first years of the Union, but the discussions never advanced because of the states' reluctant attitude towards giving up their sovereignty in the fiscal area. The recent events have stated the urgency of this issue, the tax harmonization problem is now on the top agenda of the EU politicians. Of course, the advocates of tax harmonization come with economical arguments condemning the effects of tax competition and describing the sustainability of tax harmonization.

There are three main arguments against tax competition (Theater 2005: 79-85 and Bond 2000: 35-44):

- Loss of revenue for governments. The unrestricted tax competition could lead to an eventual *race to the bottom*. This means that governments will be constraint to progressively reduce their tax rates until they would no longer have enough income to exert their functions. This would lead to an underprovission of public goods and services. The loss of revenue can also result from the speculative behavior of companies that can trick taxation by using different types of mechanisms, such as the transfer prices system.
- Distorsions to real economic behavior. For efficiency, investment should be located in the area where production can be carried out at the minimum cost. If differences in the amount of taxes determine a company's decision about where to locate, this could

result in production being carried out in a country with higher costs but lower taxes. This way resources are wasted.

- Administrative and Compliance Costs. Because of the possibilities to evade paying taxes that the tax competition offers to companies, the governments will have to invest in creating a bureaucracy specially designed to attempt to reduce those opportunities wherever possible.

Although these arguments are not to be neglected I think that the arguments against tax harmonization are stronger. I will now enumerate the reasons why tax harmonization could prove as a damaging policy within the EU.

First of all I think that the harmonization of taxes could represent a setback for the EU legitimacy. The european institutions are already facing a democratic deficit. Removing the national sovereignity regarding taxation is very likely to be interpreted by a large share of the population as an intrusive measure. The European Union, "designed like a gigantic and pachydermal welfare state, will be anything but a warranty of freedom" (Trovato 2007), and the people are more aware that the farther the power is from its subjects, the less they will be able to control it.

Secondly, it will be a discriminatory measure towards the poorer countries of the EU since it would deprive them of one of the most important comparative advantages they have in their attempt to reduce the economic gap. This would result in a form of fiscal protectionism, or what Daniel J. Mitchell nominated as "an OPEC for politicians"(Mitchell 2005).

Finally, from the perspective of future European economic development the tax harmonization will most likely have negative results. One of the obvious effects of fiscal harmonization is the incentive to adopt high tax rates. This can be seen in the case of the value added tax (VAT), which has already been harmonized at an european level. Although the minimum rate is currently being set to 15%, all of the member states have VAT rates above this level. Higher taxes means lower investment. Lower investment means less capital per worker, lower productivity and hence lower wages.

Fiscal competition, on the other hand, determines taxes to decrease and ensure prosperity and development.

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