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Economics Revision Focus: 2004

A2 Economics

European Union Tax Harmonisation

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Revision Focus on European Union Tax Harmonisation

A2 Syllabus Requirements

Reform of the European Union
Students should to be able to analyse and evaluate the advantages and disadvantages of harmonisation of taxes

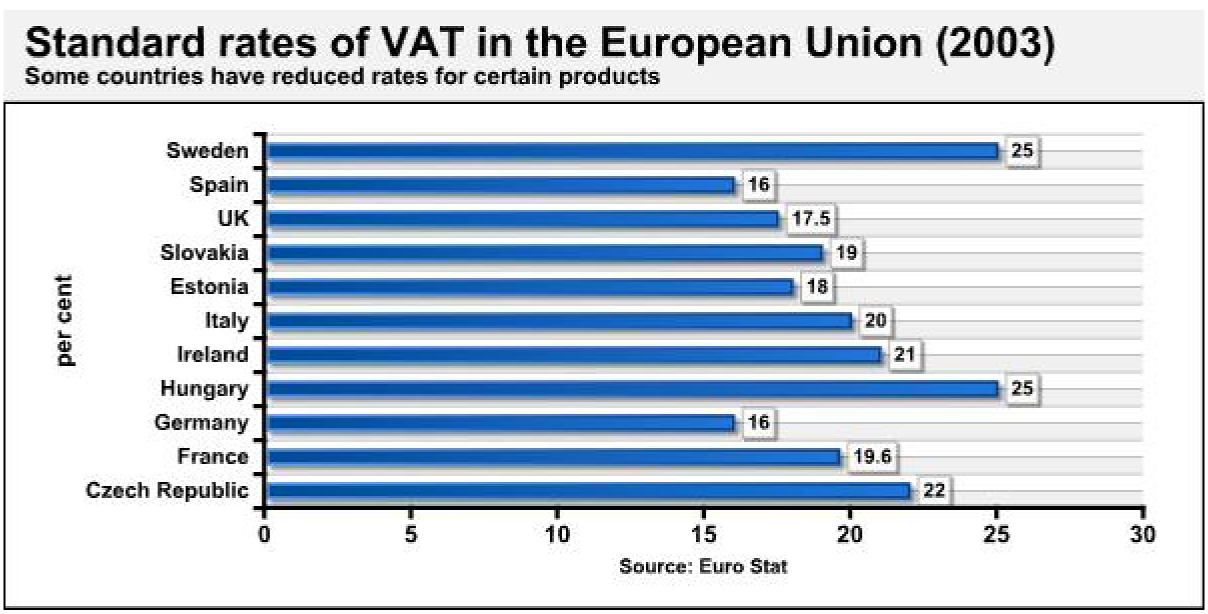
Taxation – What Might Be Harmonized?

Harmonisation of the tax system would probably include both direct and indirect taxes

Direct taxes (including taxes on labour and capital) such as income tax, social security contributions, corporation tax, wealth taxes and the taxation of saving

Indirect taxes such as excise duties (e.g. on cigarettes, alcohol and fuel), value added tax and environmental taxes (i.e. energy taxes)

Current situation: National governments retain sole responsibility for direct taxes - the amounts they raise by taxing personal incomes and company profits. EU taxation policy focuses instead on the rates of indirect taxes like value-added tax and excise duties which can **directly affect the single market**. For example there is a minimum excise duty rate for cigarettes and alcohol and also minimum duty rates for mineral fuels (e.g. oil and petrol).



There are already big differences in the tax structures of the main European Union countries The Nordic countries, Sweden, Denmark, and Finland, have relatively high shares of direct taxes as a % of their GDP.(more than 40% compared to an EU-average of 35%) whereas Ireland, Portugal and Greece has relatively high shares of indirect taxes (more than 40% versus an EU-average of 34%).

The Euro Zone countries also signed up to the **European Fiscal Stability and Growth Pact** which sought to place limits on how much each member government could borrow as a share of their national income. But the last two years has seen the effective abandonment of the pact, and fierce criticism of it from many quarters. A number of countries, among them Germany and France have pierced the ceilings for their budget deficits and the pact is now effectively dead in the water. Britain is outside of the constraints of the pact since she has an opt-out from membership of the Euro.

Arguments for fiscal harmonisation

The main supporters of greater fiscal harmonisation are **France** and **Germany**. Indeed in a recent speech just prior to the enlargement of the EU to twenty-five countries on May 1st 2004, Chancellor Schroeder made clear his desire to achieve harmonisation of direct taxes and he criticised the practice of "**fiscal dumping**" by some of the new countries joining the EU.

"The future of our nation cannot be stuck in a merciless struggle over low wages and low taxes. We want fiscal competition, but we must avoid fiscal dumping - an EU tax corridor with a maximum high and low tax is needed to prevent "tax dumping" from harming countries like Germany"

German corporate taxes are currently 38 percent - the highest in the EU - compared with 15 percent in Latvia, 16 percent in Hungary and 19 percent in Poland.

A summary of the main arguments for tax harmonisation are provided below:

1. **Improved economic efficiency:** Harmonisation of government spending, tax allowances and other tax incentives may remove some of the barriers that can distort competition within the countries of the single market and provide a level-playing field for all member nations.

2. **Labour mobility:** Differences in income tax systems and the taxation of pensions can be a barrier to the geographical mobility of labour. Only 0.1% of people in the EU move to a different EU nation each year, a figure that is significantly below that of the United States.

3. **Distrust of countries that engage in tax competition:** Different rates of corporation tax affect the relative attractiveness of an economy for inflows of foreign direct investment. Some EU governments are against the deliberate use of lower corporation tax as a strategy designed to promote investment. They argue that it amounts to "fiscal dumping"

4. **Tax avoidance and evasion:** Tax harmonisation might reduce the problem of tax avoidance and evasion. The wealthy are often able to avoid taxes by registering wealth in low tax areas, like Jersey. This benefits the low tax regimes but is a form of inefficiency as it lowers the progressiveness of the tax system of countries like the UK and reduces the finances available for public sector infrastructure projects and expenditure on public & merit goods.

5. **Reducing the risk of "free-riders" viz environmental taxation:** Negative externalities originating in one country can have significant impacts on neighbouring countries. For example, the burning of coal with sulphur in the UK has caused acid rain in Sweden. Tax harmonisation can be used to stop the free-riding problem of countries not considering the effect of their negative externalities over their borders. If countries have varying pollution tax regimes, many industries that are heavily dependent on fossil fuels may move to low pollution tax countries resulting in a negligible improvement in the quality of the environment.

Arguments against tax harmonisation

In April 2004, at an EU summit, Chancellor Gordon Brown was reported as stating that **"tax harmonisation would be "unrealistic, unjustified and unacceptable"**. The position of the British government is firmly in the anti-harmonisation camp as is the Irish government. This is hardly surprising since a policy of low taxation is widely credited as being a contributory factor to the sensational growth and development of the Irish economy over the last fifteen years.

1. **Fiscal policy – "one size does not fit all"** - The economies of Europe are structurally different, in terms of unit labour costs, size of labour supply, and access to raw materials and geographical location and advantage. Different fiscal policies are suited for each nation to offset some of their natural economic and geographic disadvantages.

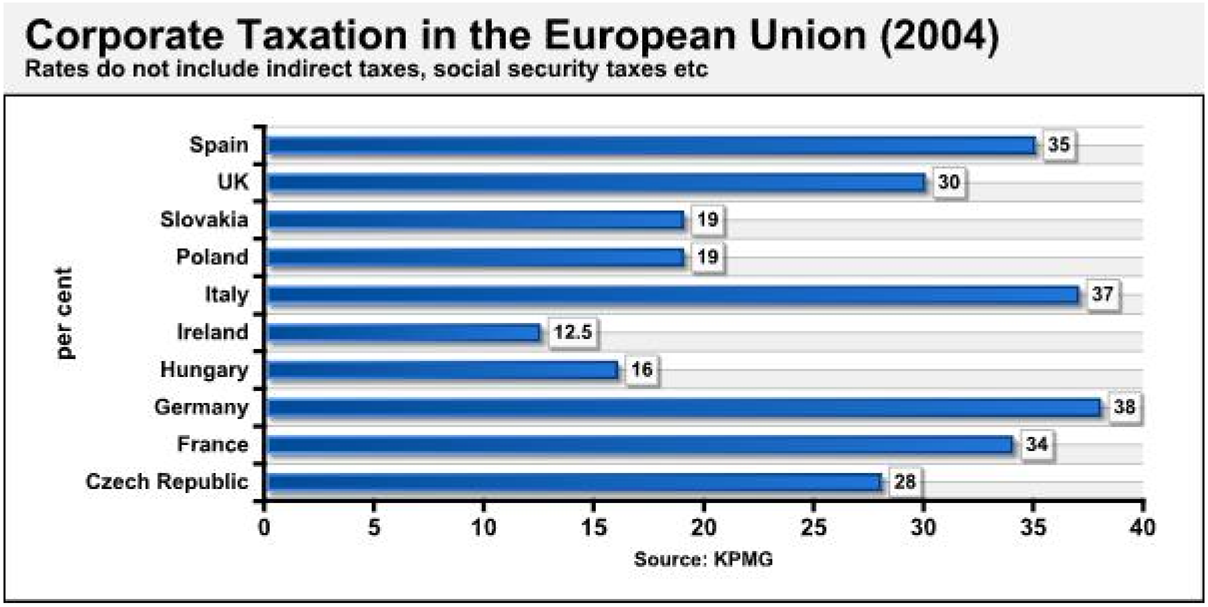
2. **Different attitudes to progressive taxation and redistribution of income and wealth**: Nations in the EU have different attitudes to what is an acceptable scale of income and wealth inequality and how progressive the tax system should be as a tool of redistribution. Sweden's tax and welfare system is more progressive than the UK's. Attitudes to inequality are normative and the fact that the UK's and Sweden's tax systems have been decided democratically suggests that a different tax system shouldn't be imposed onto the economies of each country, as this would contradict the expressed wills of the citizens of those nations.

3. **Fiscal policy and demand management.** By entering the euro, member countries of the Euro Zone lose control over their own **exchange and interest rates**. Fiscal policy is the main tool left to stimulate aggregate demand and output if the economy suffers a slowdown or a recession. If the UK ever joins the Euro the flexible use of fiscal policy will be important as interest rates set by the ECB will be set for the whole EU region and won't be designed with the sole intention to reduce the output gap only in the UK.

4. **Improving the supply side:** Fiscal policy is an important tool for the government to improve the supply side of the economy. Labour has used fiscal policy in schemes like New Deal, and in measures to take people out of the poverty and unemployment trap.

5. **Development of accession countries:** Accession countries are supportive of lower corporation tax rates to stimulate investment. Their justification is that FDI will promote growth, rising real incomes and higher employment. In the long run, if this supports the process of economic convergence with fellow members of the EU, then accession countries will be making fewer claims on EU regional funds and agricultural support programmes. Their markets will also provide export opportunities for businesses in relatively richer EU nations.

6. **Criticisms of the fiscal stability pact:** The EU fiscal stability pact has been heavily criticised for forcing governments to reduce spending in a recession, as it is doing in Germany and failing to allow the **automatic stabilisers to work through**.



Critics of the idea of fiscal harmonisation argue that individual member states of the EU should be **free to choose the tax systems that they consider most appropriate** to meet their particular economic and social needs. For example, some countries attach a greater degree of importance to using taxes to control externalities. They believe that more attention should be paid to implementing wider supply-side economic reforms within the EU to boost growth and employment rather than been forced into changing their tax systems.