Fiscal Policy Harmonization in the EU: France

The Issue of Fiscal Policy Harmonization in the European Union is extremely complicated. Given that the EU is a common market—with very low barriers to capital and labor migration—harmonization would affect each country differently depending on a variety of macroeconomic factors (population, size, affluence, etc). Also, policy harmonization has a myriad of political implications that must also be addressed: though economic efficiency may be an ideal goal, if the populace would prefer a seemingly “less-efficient” program, this would serve as a barrier to the implementation of the theoretically “ideal” program. Since the French are notorious for their high taxes and extensive income redistribution programs, this paper will address the costs and benefits of fiscal policy harmonization in the context of France’s current redistributive policies.

General Pro’s and Cons of Harmonization

This section assumes relatively few barriers to capital and labor migration across borders. Given the nature of the European Union, this is not an unreasonable assumption (Nello 2002). Since migration is relatively easy, as long as the benefits of migration outweigh the costs, capital and labor will relocate to areas where they can realize their highest returns. In other words, workers or corporations will migrate to regions where they can achieve the highest income possible. Therefore, if tax structures are not harmonized—as under the current system—corporations will move to areas with the lowest taxes (as long as the benefits of that move outweigh the costs) and workers will migrate to areas where they realize the highest real wages.
possible (e.g. lower income tax rates would lead to larger disposable incomes)\(^1\) (see Wildasin; Saving; Kessler). This should, theoretically, result in competition for mobile resources amongst countries. As labor and capital migrate to areas with more favorable fiscal treatments, countries would essentially be forced to lower their taxes relative to their neighbors; lest they realize a drastic reduction in their labor force or capital stock. Such “competition” is inefficient, as factor mobility decisions are then based on fiscal treatment rather than comparative advantages in productivity. It also greatly constrains any individual country’s ability to alter their redistributive policies (see Kessler; Wildasin).

Differing redistributive policies in one country--in a common market--have an effect on other countries because factors migrate to seek the highest income possible (as determined by taxes and government transfers) (see Kessler). Such migration compromises the effectiveness of an individual country’s income redistribution policies: the host country realizes an influx of migrants who are net receivers of the social program, subsequently increasing the financial obligations necessary to implement said program. Taxpayers who would be considered "net donors" to this program would therefore be hit with higher taxes while realizing no substantial returns. This may result in an outflow of the very citizens necessary to finance the welfare program. In short, with relatively free movement of labor, differing redistributive policies would result in an inflow of net benefactors and an outflow of net donors (Wildasin). Therefore, “in the competition for the lowest possible [redistributive] standards, the European Welfare State [is] exposed to strong erosive forces which threaten its very substance” because “the benefits of the social welfare state will attract migrants who are net recipients of public resources” (Sinn 2000).

A solution to this problem would be tax harmonization across all countries—every member of the EU would coordinate their taxes and government spending programs. This would
essentially eliminate the distortions to factor markets resulting from differing tax structures and redistributive policies. Since tax rates would no longer affect factor migration decisions, factors of production would migrate to areas where they would enjoy a comparative advantage, resulting in allocative efficiency across all member states (Anderson 2007). This allocative efficiency is the main benefit of harmonization.

Consequently, members of any given country--under the currently "un-harmonized" system--would realize a net gain in welfare if tax harmonization is implemented, as it would eliminate all unnecessary and discriminatory tax burdens on the populace (e.g. net donors would no longer bear an unnecessarily large financial burden, and net receivers would be distributed more evenly so as to lessen any one country's obligations to them) (see Saving; Kessler; Wildasin).

The major cost of harmonization is the loss of autonomy that individual countries now have in regards to fiscal policy. Since taxes are the base of revenue for governments, harmonizing tax rates necessarily implies equal levels of government spending for all countries. Therefore, every country must coordinate to realize equal levels of income redistribution and equally extensive social safety nets. This may prove incredibly difficult to implement. As tastes and preferences can differ drastically from country to country, compromise would be inevitable. Countries which prefer extensive fiscal policies and income redistribution may have to make sacrifices in order to coordinate with countries which prefer less extensive programs (and vice-versa). Also, harmonization would limit the extent to which countries could engage in “deficit spending” and various other fiscal policies (such as changing the tax rate) to pull themselves out of recessions². If a country were to deviate from the coordinated policies, it would unleash vast distortions in factor markets as capital and labor move to areas where they will receive more
favorable fiscal treatment (see above). Therefore, though the efficiency implications of fiscal policy harmonization are great, they are met by a myriad of political problems due to differing tastes and preferences regarding the government’s role in the economy.

The Case for France

Under the EU's currently unharmonized system, the European continent has been realizing a large degree of labor migration. This has typically been migration from former Soviet Bloc countries in Eastern Europe into the more developed, larger, Western European Economies. Britain has been especially hard hit, though France has also realized an influx of labor. However, since France has abnormally extensive redistributions programs--and therefore relatively larger tax rates--the migration of labor out of France into other countries (e.g. Britain) is of greater importance. Since France's tax rates are higher than those in Britain, France is experiencing an outflow of workers to Britain and other countries (where they achieve larger disposable incomes due to lower tax rates). Likewise, according to economic theory, differing redistributive policies, in addition to inducing net donors to leave the country, should also induce an inflow of net receivers. France's abnormally extensive welfare systems make it especially appealing for net benefactors to migrate into the country. This is draining France’s tax system. The citizens necessary to finance their redistributive policies are leaving the country to reside where their tax burdens are not as great, thereby reducing the size of the population that would be considered financers of the programs. Likewise, workers and corporations in need of government assistance (“net receivers”) are entering the country and thereby increasing the amount of financing necessary to implement the redistributive programs.
In light of these problems, it would be in France's best interest to advocate on behalf of fiscal policy harmonization in the EU. This would serve to both induce allocative efficiency as factors of production move to areas where they enjoy a comparative advantage (rather than just a number of subsidies or tax breaks) and also to eliminate much of the drain on France's tax system that is a result of labor migration into and out of France.

However, it is important to note that the French--with their large socialist party--are especially fond of extensive welfare systems. The loss of autonomy resulting from fiscal policy harmonization may force France to cut back on a number of its redistributive policies. This may result in a political backlash. However, since the benefits of harmonization greatly outweigh the costs, harmonization must still be pursued. In light of potential political friction, this pursuit must be accompanied by a great deal of prudence. Before any large-scale changes are made, the tastes and preferences of the French people in regards to the government's role in the economy must be changed as well.

Notes

1 Note: This assumes the absence of a language barrier. Since this paper deals with long-term effects, the economic costs resulting from language barriers would be minimized.

2 Note: For a more detailed explanation on fiscal policy to eliminate recessions, see Abel, Bernanke, and Croushore's *Macroeconomics* chapter 11 pp. 416-19.


Fiscal Harmonization and the Republic of Ireland
INTRODUCTION

The effects of globalization, coupled with the abolition of trade barriers and physical border controls, have enabled capital and labor to move relatively freely across the borders of the European community. While the positive consequences of the improvement of the allocation of resources will help most European economies, new problems arise from tax-competition among the European community. The lowering of tax rates on capital can create a ‘race to the bottom’ by countries seeking to attract, or maintain, factors of production. Tax coordination, or fiscal harmonization, has both positive and negative effects for the European Community. This paper will present the general pros and cons of fiscal harmonization and evaluate the relevance of those pros and cons in regards to Ireland. What will result is a general recommendation of whether or not Ireland should participate in tax harmonization with the rest of the European Community.

PROS

The major benefit of tax harmonization is its ability to prevent firms and individuals from basing location decisions on relative tax rates. If tax differences are significant, firms and individuals have an economic incentive to relocate to countries that have lower tax-rates given that relocation costs (movement of capital, language and cultural barriers) are not too high. This induces countries to start a ‘race to the bottom’ where each country lowers corporate and income taxes to induce capital and labor emigration into their country. Lower taxes means that the government can provide less public goods and services so, theoretically, social welfare decreases (Zodrow, 2003). Tax harmonization impedes the movement of capital and labor and increases the amount of aggregate revenue from taxation (Dehejia, 1999). This additional revenue allows governments to provide the public goods and services necessary to maintain overall welfare.
One particular benefit of increased government revenue from tax harmonization is the protection the participating governments can provide its citizens from income uncertainty. The social benefits of job security from government redistributions, although not measurable, are thought to be significant. The labor force is more efficient when they have job security (Zodrow, 2003). Another benefit of tax-harmonization is its protection against tax competitions incentive for similar states to specialize in production. The logic behind this argument is that given tax competition, “…some states would choose low taxes, low expenditures and production of the capital intensive good while others choose relatively high taxes, high expenditures and production of labor-intensive goods.” This arrangement is inefficient and is eliminated, or reduced, under tax harmonization (Wilson, 1987). Some scholars have noted that tax harmonization would reduce the compliance costs of tax filing since firms and individuals could now file under a single set of corporate tax or income tax rules (Zodrow, 2003). The extent of the social benefit of this point is hard to determine but significant nonetheless.

**CONS**

The negatives associated with tax-harmonization are also related to the location decisions of firms and individuals but other relevant factors come into play as well. Tax-competition may have benefits that offset the under provision of public services that results from ‘the race to the bottom.’ One important consideration of fiscal integration in the European Community is that while it may stop capital movement among member states, it has no effect of taxation decisions of non-members. For example, what is to stop the Ukraine from lowering its corporate tax-rates in an attempt to attract industry from the now fiscally harmonized European Union? Another negative of tax-harmonization is the incentive that participating nations have to increase taxes
once a capital location decision has been made and there is no longer a risk of capital flight. Once a firm builds a factory the investment has already been made and that capital is now immobile. A country could easily start creating additional tax requirements for already existing, accumulated capital (Keen, 1993). This leads into the next point that governments are unable to commit to a sustained future tax rate. Since the requirements of each European nation are different and continually changing, future fiscal requirements are variable. A harmonized tax rate would restrict nations in governmental capabilities or encourage mismanagement and overlooked tax-evasion (Keen, 1993). Additionally, the broad range of social and cultural expectations of government involvement in public life means that different regions require different fiscal policies. The political implications of this are great since some states are likely to be net losers from tax-harmonization and would consequently put up a huge political fight against it. Interest groups in each country would put up a significant fight to avoid unnecessary additional taxes in the name of overall social welfare (Zodrow, 2003).

Another consequence of tax-harmonization is a loss of control of ‘health and distributional’ policies of individual governments (Keen, 1993). Taxation is a tool often used by governments to implement social policies and effect citizens behavior. For instance, some governments add a disproportionately high tax on cigarettes to discourage smoking. Tax harmonization in the European Union, on an extreme level, would subject each individually diverse nation to the policies of the aggregate. Furthermore, the social diversity from each state to the next requires different taxes (Keen, 1993). Some scholars argue that problems with increased corporate taxation in the form of harmonized capital income tax creates inefficiencies in corporate decision making that could potentially offset the welfare gains of tax harmonization (Zodrow, 2003). Finally, tax competition has a unique ability to keep government bureaucracy in
check. Since most governments and policymakers seek to expand their budget by increasing revenue, the potential for the creation of a ‘leviathan’ government is great. ‘Leviathan’ has significant inefficiency costs associated with large bureaucracies. Tax competition keeps the tendency of governments to overspend in check thereby reducing government bureaucracy (Keen, 1993)

**TAX HARMONIZATION AND THE REPUBLIC OF IRELAND**

For the past ten years Ireland has practiced a low corporate tax rate (≈10% compared to 15-60% in the rest of Europe) to encourage foreign direct investment. This policy has attracted many high-tech multi-national corporations to headquarter in Ireland. The economy of Ireland improved considerably throughout the 1990’s as a result of Ireland’s attractiveness to foreign firms. Companies like Microsoft, HP, Apple and Intel have their European headquarters in Ireland and as a result, Ireland produces 25% of European computers. As an entertaining quote from Capitalism Magazine concisely puts it, “Thus through tax cuts, the land of pubs and drunks has been "miraculously" transformed into one of high-tech firms and entrepreneurs.” Even after undercutting the European corporate tax rate Ireland still maintains a welfare state with government healthcare and education. The government also oversees transportation, electricity and mail. The relatively high standards of government provision of public services indicates that Ireland doesn’t stand to gain from tax harmonization on the basis of bettering public services. The wealth of the Irish people is principally held in property and one of the major economic resources Ireland has are its large pastures. These factors serve as a bit of protection from capital outflow. Large pastures are a non-transferable resource. Since the 2004 accession many Europeans have immigrated to Ireland to take advantage of its strong economic growth.
Accordingly increasing its labor force has increased. Ireland should not be worried about labor outflow from taxation.

The official recommendation of this paper is that the Republic of Ireland should resist the European Union’s attempts at tax harmonization. The low corporate income tax maintained by Ireland has essentially transformed the country from poverty stricken too prosperous in less than a decade. The increasing foreign direct investment has resulted in an Irish economy often referred to as the “Celtic Tiger.” Any welfare lost from lower tax revenue has been replaced (many times over) by the economic boom resulting from investment. A tax-harmonization agreement would essentially deprive Ireland of its economic edge. Additionally, agreeing to a tax harmonization program would probably result in capital outflow since the high-tech companies who originally came to Ireland for its low interest rate would go seek lower tax rates abroad. In the distant future, once a plateau of capital investment is reached (if it ever is), Ireland might consider tax harmonization to protect the already established industry if outflow to other European nations becomes a problem.


