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EU TAX HARMONISATION

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There is a heated debate taking place at present amongst tax experts in the EU, and outside it, on the subject of tax harmonisation. Unfortunately, as is the tendency with these debates, it has become highly politicised, which too often results in the arguments being advanced by the various protagonists owing more to their political philosophy than to considerations of fiscal policy.

1 hope, today, in this forum, to be able to decouple the fiscal arguments from their political baggage and to consider this issue from a purely fiscal standpoint. I hope, also, to convince you that a measure of fiscal harmonisation is essential for those Member States participating in EMU. However, some forms of harmonisation are better for the economy than others. This paper seeks to identify the type of harmonisation that is best suited to the requirements of Euroland.

It is first necessary to define what one means by the term "harmonisation" in this context. Harmonisation does not mean "standardisation" or uniformity. Harmonisation means bringing elements together in a state of harmony, which implies equilibrium, balance, proportion and compatibility. Surely, these are the characteristics that one would seek in a European taxation system. Harmonisation is the elimination of discordant degrees of disparity; it involves approximation but does not require total conformity.

It has to be remembered that EMU stands for Economic and Monetary Union. This is important because the two are irrevocably linked - you cannot have one without

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I should like to stress that the views expressed in this paper are my own and do not necessarily reflect those of any organisation of which I am a member or with which I may be associated.

the other. Monetary union requires economic union in order to be sustainable and an economic union (as opposed to an economic alliance) requires harmonisation of budgetary, fiscal and monetary policies.

History does not record any examples of enduring economic and monetary unions which have not been accompanied by political union. In the past, political union has preceded economic union, which, in turn, has been the precursor of monetary union. Europe is attempting to reverse this order.

In free-market conditions, the value of a nation's currency is determined by the perceived performance of that nation's economy and fluctuations between the economic performance of individual states are primarily adjusted through the mechanism of the exchange rate. When a group of nations enters into a monetary union, the exchange rate mechanism is no longer available; it follows that, in order to avoid stresses of unacceptable magnitude on the other adjustment mechanisms, their economic performances must be aligned as closely as possible; but economic convergence cannot be sustained without policy convergence.

A successful monetary union between significant numbers of states must, therefore, be accompanied by a fiscal union, with any locally-differentiated taxes raising only relatively insignificant amounts in terms of GDP. The most obvious example is the USA, where there are different taxes in different states but the differences in the amount of revenue raised, as a percentage of national GDP, are minimal. The overwhelming majority of tax is imposed at federal level and is the same throughout the USA.

By contrast, the situation in Euroland (and in the EU) is markedly different. The rates of total tax revenue in each of the Euroland Member States as a percentage of national GDP vary from 32.3% in Ireland to 48.3% in Belgium. Such enormous differences cannot be accommodated within the framework of a single economy.

You may ask, "Why not?" The answer is at once simple and complex. In its most simple form, it centres on the fact that the total amount of tax as a proportion of GDP represents resources which are transferred from the wealth-creating private sector to the wealth-consuming public sector. Now I would not wish to be misunderstood on this issue; I am not saying that private expenditure is good and public expenditure is bad; far from it. Government has a function to fulfil and must have the wherewithal to fulfil it but it is an inescapable fact that resources which are diverted from the wealth-creating sector are not available for the generation of new wealth and, as a rule, the higher the proportion of GDP which is siphoned-off into wealth-consuming activities, the less there remains for wealth creation and the lower the prospects for economic growth.

Of course, differences in the total burden of tax as a percentage of GDP between individual countries can be offset by the operation of other factors, notably national mean productivity and the relative degree of efficiency in national labour and product markets but, other things being equal, and, with the unifying forces which are currently at work in every field and at every level within the EU, other things are increasingly becoming and will continue to become more equal, the total burden of taxation as a percentage of GDP will emerge as a dominant factor in determining economic potential.

The coincidence of monetary and fiscal union within the USA is no accident. There are several good reasons for it and all of these reasons apply to the Euro area.

The first reason why fiscal union goes with monetary union is the need for consistent economic management. The various elements of this management, budgetary, monetary and fiscal policy, interact with each other. Movements in one will create changes in the others. In particular, there is a balance to be maintained between monetary and fiscal policies. A tightening of monetary policy may well require a loosening of fiscal policy, and vice versa.

Neither a monetary policy nor a fiscal policy will achieve its desired effect without the appropriate response from the other type of policy; changes in either therefore need to be coordinated. It is easiest to achieve this coordination when each policy is the responsibility of one single authority (not necessarily the same authority for both) and the jurisdictions of the monetary authority and the fiscal authority cover the same geographical area.

In the Euro area, if an individual Member State continues to set its own fiscal policy, it will have no idea whether the European Central Bank (ECB) will respond to its fiscal decisions in an appropriate manner; if other Member States are taking contrary decisions, the ECB will be unable to respond appropriately to all of them. Thus, its monetary policy, while being suited to the fiscal decisions of some Member States, might be precisely the reverse of what other Member States need.

Therefore, in order to ensure economic stability within its own territory, each Member State would be forced to take its cue on fiscal policy from the monetary policy of the ECB. Thus, fiscal sovereignty would effectively be substantially reduced. This process has already started.

Moreover, even at national level, governments are no longer seen as the sole arbiters of fiscal policy. As the Presidency Conclusions of the Cologne European Council state, the coordination of economic policy requires a macro-economic dialogue between a number of players and those players will increasingly tend to be organised, or at least coordinated, at a European level. The question of national fiscal sovereignty is, therefore, not an issue; it has already been consigned to history.

The ECB, in turn, will not be able to pursue a coherent monetary policy if it has to respond to widely divergent fiscal policies in the Euroland Member States. Although the Stability and Growth pact will impose some constraints on these fiscal policies, it will not control them. The ECB would have an easier task and would be able to make better decisions if its opposite number on the fiscal side were a single authority determining fiscal policy for the Euro area as a whole; in other words, fiscal harmonisation.

The Commission recognises these issues in its Annual Economic Report for 1999 (COM (1999) 7 final) when it says "There is thus a clear need for co-ordination, both between economic actors and between countries, to ensure that appropriate combinations of economic policies are simultaneously conducted at the Euro area level and in the individual Member States."

The above argument about economic management concerns the fiscal stance - the tightening or loosening of policy by adjusting the difference between tax and spending. A fiscal stance is said to be tight when the tax take exceeds public expenditure as a proportion of GDP, regardless of whether tax is 36% and spending 35% of GDP or tax is 51% and spending is 50% of GDP. Conversely, the fiscal stance is deemed to be loose when these figures are reversed.

However, as has already been indicated, levels of taxation and public spending as percentages of GDP will also need to be brought into harmony and, without necessarily aiming at complete uniformity, a greater degree of approximation than currently exists will have to be achieved. There are two reasons for this.

The first, and most important, of these reasons stems from the need to respond to asymmetric shocks. Prior to EMU, Member States could respond to economic shocks with a combination of fiscal and monetary measures and were free to decide for themselves on the most appropriate policy mix; if one state needed a loosening of policy, it could have it without constraining the ability of another state to respond to the shock in a different way.

EMU, by taking monetary policy out of the control of Euroland Member States, has drastically curtailed this freedom. Only fiscal policy is left and, as was outlined above, that can only be exercised within the constraints imposed by the monetary policy of the ECB.

Thus, once EMU is fully established, Member States will have lost their ability to manage their way through economic shocks that affect different countries to different degrees.

One way in which the impact of asymmetric shocks can be reduced is by the relocation of labour. This is what happens in, for example, the USA; but, because of linguistic and cultural differences, and the consequent attachment of people to their native country, labour mobility in Europe is less than half that in the United States and, despite concerted attempts to improve this situation, it is getting worse rather than better.

Another mechanism for countering asymmetric shocks is cross-subsidisation by fiscal transfers and it is generally accepted that, to some extent, this process will have to take place within Euroland. It is incorporated as a measure of last resort in the Stability and Growth Pact but it is unlikely to be politically acceptable within what will, at least for the foreseeable future, remain a collection of separate states, unless there is considerable harmonisation of total tax and spending levels. Without such harmonisation, there is likely to be political resistance to subsidising high levels of expenditure in other Member States.

The scale on which such aid might be needed is illustrated by the MacDougall Report (European Commission 1997). That report noted that existing monetary unions disburse around 20% of GDP centrally and that the Euro area would need to disburse at least 5% to 7%. The current EU budget is less than 1.5% of Euroland GDP.

This suggests that a marked centralisation of fiscal policy for the Euro area will be needed in any case. Some of the central disbursement would replace existing disbursements within Member States and some of it would be new disbursement; thus, the total of fiscal transfers within the Euro area would increase.

The second reason why total tax and spending levels will have to be harmonised within Euroland is that no one Member State will be able to keep the benefits of its spending to itself. Its taxpayers will expect to get the benefits of the corresponding public expenditure but, with increasing levels of cross-border trade and personal mobility, it will become clear to the citizens of any one state that the benefits of its public expenditure are being shared with the citizens of other Member States.

This sort of benefit sharing can already produce tensions on a smaller scale within Member States, as when a high-spending region finds its facilities being enjoyed by people from surrounding areas who do not pay the region's high taxes. Monetary union notwithstanding, a government must still defend its economic policy on the grounds that it benefits the people within its national jurisdiction.

Tax harmonisation, if it is to come about, must take the form best suited to the promotion of sustained non-inflationary economic growth and the creation of employment. This means that tax rates must be as low as possible within the context of preserving and enhancing the European social model and the method of harmonisation must retain the greatest possible flexibility for the Member States.

The economy to which the European Union aspires is one of high economic growth and high employment. The adverse social consequences of high unemployment are all too obvious and the benefits of economic growth in improving the lot of all citizens are self- evident.

The evidence to date is that it is very difficult to have high growth, high employment and high taxes. Some Member States have high growth with high taxes but usually at the expense of high unemployment. Indeed, if one accepts the central thesis that transfers from the wealth-creating sector to the wealth-consuming sector diminish the potential for future economic growth, then it follows that, other things being equal, high-tax countries will be low-growth countries and low-growth countries are likely to exhibit high levels of structural unemployment.

High taxes in the Euro area would also threaten growth and employment when set against a world economy in which lower taxes were the norm. In this context, it should be noted that total taxes as a percentage of GDP are around 33% in both the USA and Japan.

The European Commission recognises this in its 1999 Annual Economic Report, when it says "..since the mid-1970s, the Union has never regained a high, sustained, non-inflationary economic growth path as it was repeatedly confronted by macro-economic obstacles to growth and failed to make sufficient progress in improving the functioning of its product, service, capital and labour markets. As a consequence, unemployment has become deeply entrenched in the wheels of the Union's economy....".

The Commission goes on to say, "Moreover, it will be necessary to create room both for long-overdue reduction in large tax wedges, especially as regards low-income workers, and to prepare for the burden on the budget of an ageing population .... governments must seize all opportunities both to improve the quality and efficiency of government spending and to make taxation more employment-friendly through lowering the overall tax burden and altering the structure and incidence of taxation."

The Commission draws the conclusion that, "..high taxes may create disincentives to invest and work by lowering the net returns to such activities and bearing down on an economy's international competitiveness. Moreover, they encourage tax avoidance and evasion, which are economically costly."

It must be stressed that lower levels of taxation need not and should not be achieved at the expense of the European social model or by dint of reductions in essential public services. Tax reductions will need to be made primarily by curtailing public expenditure but this can be achieved by more efficient utilisation of existing resources, better targeting of welfare services and more effective prevention of fraud.

As the Commission points out, "During the 1990s.... sub-optimal functioning product and labour markets, high tax pressures and inefficient welfare systems bore down on the EU's growth and employment performance." It is time to redress this situation.

We now come to the second issue; if, as I hope you do, you now accept that a measure of tax harmonisation is an essential prerequisite for sustained monetary union, the question arises of what form that harmonisation should take. The form of tax harmonisation could be either minimalist or maximalist in nature. In a minimalist system, harmonisation would be limited to what was strictly necessary for the purpose of achieving an economic union. By contrast, maximalist harmonisation would seek to produce absolute conformity, not only of tax rates but of the tax base and the tax regulations. I favour the former approach.

While it would not be possible to achieve an economic union or to sustain a monetary union with the present degree of disparity of total tax as a percentage of GDP between the Euroland Member States, complete harmonisation to a single rate is not necessary. In order to facilitate convergence in economic performance one need do no more than harmonise the total burden of tax as a percentage of GDP. Even here, complete conformity is not required; it would probably suffice to have a band of total tax as a percentage of GDP with a dispersion of 2 or 2.5 percentage points about a mean rate.

By the same token, if the total tax as a percentage of GDP were brought within acceptable limits, it would not be necessary to set individual limits for the various elements of taxation such as corporation tax, income tax, wealth tax and labour taxes. Member States could retain their freedom to select the tax mix which was best suited to their individual circumstances, provided that the total tax remained within the permitted range.

The weighted average of total tax as a percentage of GDP in the Euro 11 in 1998 was 43.4%. A simple process of harmonisation based on existing levels of taxation in the Member States would lead to this, or something close to it, being the mean point. This would give a permitted range of total tax as a percentage of GDP of around 40-45%.

However, this would simply result in the average burden of taxation remaining at its present level, whereas the Commission has convincingly stated the case for lower taxes and political leaders have recently echoed this call. In order to give effect to this policy, a rate band of 37.5-42.5% might be more appropriate.

Constraining the level of total tax as a percentage of GDP within a 40-45% band might, at first sight, appear an impossible task for some Member States which presently tax and spend at significantly higher levels but naturally do not want to reduce current levels of social provision for their citizens. A target band of 37.5-42.5% would appear even more difficult to achieve.

In fact, as the table below shows, only four of the Euro 11 currently have tax levels which would put them above the upper limit of a 40-45% band and for even the highest of these to comply would require a reduction of no more than 3.3% in total tax as a percentage of GDP. Only one further country is currently above the upper limit of the 37.5-42.5% band, and that by no more than 0.4%. It should, therefore, be possible to attain this degree of fiscal convergence if the political will exists.

EUROLAND MEMBER STATES (Total tax as a percentage of GDP (1998)

Austria	46.5
Belgium	48.3
Finland	46.5
France	47.6
Germany	42.2
Ireland	32.3
Italy	42.9
Luxembourg	42.5
Netherlands	44.5
Portugal	36.5
Spain	36.9

Source: European Commission

A much greater difficulty would be faced by those Euroland members which would be required to raise their tax levels to come within the lower limit of these bands. Three countries fall into this category and one of them would need to increase the total burden of taxation by no less than 7.7% to come within the higher band or 5.2% to meet the minimum requirements of the lower band. Furthermore, such a move would run counter to the Commission's expressed wish that taxes should not be raised in any Member State and should rather be reduced. Indeed, a tax band of 32.5-37.5% of GDP would be more in line with the Commission's desire to see taxes reduced and such a rate would certainly improve the competitiveness of Europe's economies but it is unlikely that the necessary political consensus could be achieved in the foreseeable future.

There is, of course, a broad range of intermediate options between the minimalist and maximalist approaches but I would favour the system which will achieve the necessary degree of harmonisation for effective economic union while retaining to the greatest possible extent the ability of Member States to make their own economic policy decisions. This is in keeping with the principle of subsidiarity, which reserves to the Member States those decisions which can most effectively be made there and accords to the Union only such powers as require a centralising influence.

Preserving the essential elements of the European social model while simultaneously reducing the burden of taxation might seem a difficult feat but the problems could be overcome by reducing other areas of government spending, by restructuring public expenditure and by the better targeting of social benefits.

It is acknowledged that, in whatever direction the change has to be made, the adjustment process will be difficult and painful and might have to be spread over a period of time but the difficulty of a worthwhile project should never be accepted as a reason or an excuse for not embarking upon it. Nothing would ever be achieved in that way.

However, given the resistance which initiatives for even modest measures of tax reform have consistently encountered from the Member States, a competitive, market-led move towards converging tax rates and systems is likely to be more effective than any attempt to impose one.

To sum up, it must be stressed that I do not favour tax harmonisation for its own sake but as one essential element in maintaining that degree of convergence of economic performance which is necessary within an economic union if its adjustment mechanisms are not to be subjected to potentially unsustainable pressures.

With the removal of the exchange rate mechanism, variations in the economic performance of the Euroland Member States can no longer be compensated by this means. Their labour and product markets will, therefore, have to bear the brunt of the adjustments required by fluctuations in their economic performance, as well as their need to react to country-specific economic disturbances; if this process is not to result in unacceptably high levels of unemployment in some Member States, which could create dangerous social tensions within the Community, then divergences in their economic performance must be kept within quite narrow limits.

To achieve this will require, inter alia, that the total burden of taxation as a percentage of GDP in the Euroland Member States be brought into much closer alignment than is currently the case. I believe that this can best be done by setting a band for total tax as a percentage of GDP. I do not consider that harmonisation of the rates of individual taxes would be required. I hope that you can agree with these propositions.

I accept that this will create problems, for those Member States which currently have tax levels substantially in excess of, or below, whatever range is selected, but I consider that, if EMU is to be successful, this is a necessity and not an option. In my view, EMU cannot succeed if the economic performances of the Euroland Member States diverge to a degree which the adjustment mechanisms which remain available cannot correct and it is highly questionable whether the EU, in its present form, could survive the failure of EMU.

Obviously, if such a measure were to be implemented, it would be a requirement for any future applicants for membership of Euroland to bring their total tax as a percentage of GDP within the stipulated band prior to being admitted to membership of EMU.

I would also endorse the call which the Commission has made in its Report on the Economic situation for a general lowering of taxes. In an increasingly globalised and increasingly competitive world, the EU Member States cannot afford to impose taxes at levels which drive away capital, undermine competitiveness, create unemployment and thereby erode the tax base itself.