SWP Comments

Stiftung
Wissenschaft und
Politik
German Institute
for International and
Security Affairs

Pressure from the East European Member States

Tax Burdens, Locational Competition and Reform Requirements within the EU-25

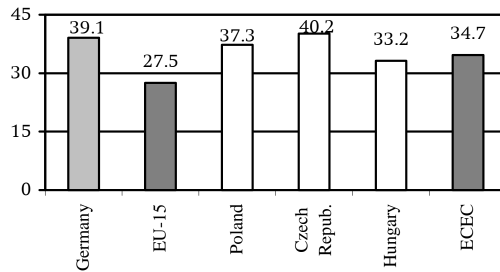
Ognian N. Hishow

The discussion presently taking place in the large Eurozone economies about the reform of the social welfare state is dominated by two assertions: Western Europe as an investment location is too expensive due to its high tax burden and, second, countless jobs are threatened from low-wage competition from the new EU member states. These claims are only partially true. Whereas the overall tax load in France is above the EU-15 average, the German tax load lies in the middle range. In addition, the export of jobs to new member counties has been declining since 2003. The reforms introduced in the EU and Germany subsumed under the headings of the Lisbon Strategy or Agenda 2010 are not solely in response to EU eastward expansion. Nonetheless, EU extension has contributed to an increased willingness to implement reforms and has stimulated, for example, efforts to adapt the structure of tax revenue in an effort to meet global challenges. It is hardly accurate, however, to speak of a "race to the bottom," which has supposedly been touched off by the new EU members. What is needed is the elimination of obstacles that hamper investment, growth and employment.

Even before EU expansion an intense discussion arose over whether the new members would endanger jobs in Western Europe as a result of unfair practices. Indeed the East Central European (ECE) economies have attracted more than 130 billions Euros in the form of foreign direct investment since the political upheavals of 1989/90. Is it possible that the investment location bonus of the Eastern Europeans is due to their comparatively lower social standards? A comparison of tax revenue structures by country clearly negates this question. With respect to the ratio of social insurance contributions to tax revenue, Germany leads in fact within the EU-15 with 39.1%, but for the ECE countries (ECEC) a ratio in this range is typical (see Figure 1, p. 2). Furthermore, social insurance contributions at 34.7% of the total tax revenue play a larger role in these countries than in those of the old EU, where the average is 27.5%.

High social insurance contributions also make work more expensive in East European countries. Nevertheless, they are still

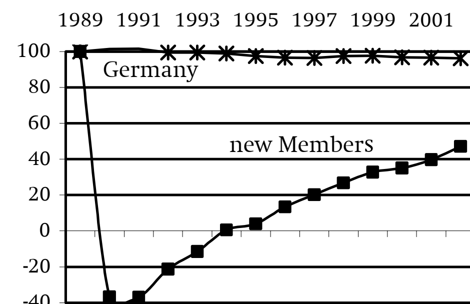
Figure 1
Percentage of social insurance contributions in the total tax revenue in the EU-25 (for Germany and EU-15 2000, ECEC 2002)



Source: UN Economic Commission for Europe, ***Economic Survey of Europe***, 2004, No. 1, Geneva 2004, p. 136.

ahead of the West when it comes to labor costs, an advantage that came about in the early nineties. In this decade industrial wages increased more slowly than producer prices, which together with a growth in nominal gross domestic product GDP) per employee led to a considerable reduction in real unit labor costs. In Germany and in most of the western economies they remained almost constant—to the disadvantage of western suppliers, who were then forced to invest more in the transformation countries.

Figure 2
Real unit labor costs in industry in the new member countries and in Germany (for Germany 2003/1991), 1989 = 100



Source: European Commission, ***European Economy***, No. 4, 2003, Brussels 2004, pp. 11ff; UN Economic Commission for Europe, ***Economic Survey of Europe***, No. 2, 2003, Geneva 2003, pp. 116ff.

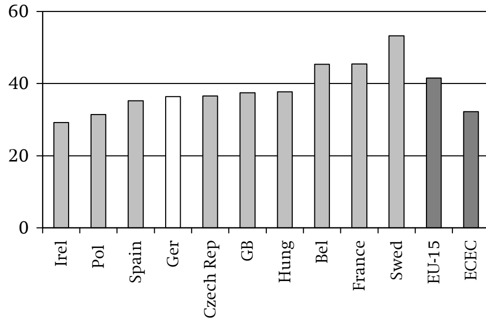
Particularly in the early years after the opening of the East the young economies had the reputation of being especially cost-effective while having a well trained, i.e., productive, labor force. In the meantime their cost advantage is diminishing (see Figure 2). This change is due to the general convergence of productivity and the hourly wage rate that took place as wages shot up in the highly productive industries modernized with foreign direct investment. Furthermore, the income increases in these industries have resulted in a general rise in wages in other areas, particularly in the service sector, which is not accompanied by an increase in productivity. This in turn decreases the competitiveness of the ECEC as an investment location. Capital and investment flows do not, however, follow the pay differential alone. They are usually driven by a calculation of all factors that influence long-term earnings, whereby the tax advantages can be the most important aspect.

Tax policy as a location factor

Critics of the competitive situation in the expanded EU point to a lower public sector share in GDP or underdeveloped social standards in the ECEC that attract direct investment from Western Europe and Germany. But in fact, the German tax burden, including social insurance contributions, has been below the EU-15 average for years. Other large economies, such as France, Italy and even Britain, have a higher overall tax ratio. And several Eastern European partners have the same or an even higher ratio than Germany (Figure 3).

What has proven disadvantageous in the world-wide tax competition turns out to be less the burden on labor than the burden on capital. The low tax burden on capital in the new member states encourages direct investments in production forms that are both capital and technologically intensive and contributes to an improved quality in the capital stock in these countries.

Figure 3
Rate of taxation, EU-15 2001, ECEC 2002 (as % of GDP)



Source: UN Economic Commission for Europe, *Economic Survey of Europe*, 2004, No. 1, Geneva 2004, p. 134.

Table 1
Corporate tax revenue, 2002 (as % of GDP)

Czech Republic	4,6	Poland	1,9
Slovakia	2,8	ECE EU members	2,2
Hungary	2,3	Germany	1,8
Latvia	1,9	EU-15	3,9

Source: UN Economic Commission for Europe, *Economic Survey of Europe*, 2004, No.1, Geneva 2004, pp. 134 and 137.

The result has its price: Foreign direct investment promotes productivity per employee and the quality of human capital, but as a negative effect fewer jobs are created. Underemployment has stabilized in Poland, Slovakia and in the Baltic countries at a high level and is six percentage points higher than in the EU-15 (14.1% and 8.1% of the potential labor force, respectively). On average for the ten new EU countries, one million Euros of direct investment creates about 70 jobs in Poland, 60 in the Czech Republic and 50 in Hungary, but over 150 in China. This is why the new EU member states will not be a low-wage area in the long term and will gradually lose their competitive edge as an investment location for unskilled work. This is also why the efforts in Germany to reduce the burden on labor are moving in the right direction. With the reduction of non-wage labor costs, Germany as an investment location will gain in competitiveness vis-à-vis the ECEC.

ECEC policies that aim at the reduction of taxation on capital can also be viewed in light of the previous experience of the EU-15 and Germany. According to UN figures, in 2002 Germany registered—despite the highest effective rates in the EU of just under 40%—a corporate tax revenue of approximately 1.8% of the BIP, whereas Hungary, Slovakia and the Czech Republic ranged between a quarter and double more than that (Table 1). With a reduced and simplified corporate tax system, the ECE countries expect to overcompensate for tax loss by incurring increased investments and more growth (the so-called “Laffer effect”).

Conclusion

The reforms designed to relieve businesses and create jobs in response to low growth and high unemployment rates are aimed at eliminating obstacles to growth and contributing in the long term to the implementation of the EU’s Lisbon Strategy. In some EU countries the reform process has begun (France), in others it is quite advanced (the Scandinavian countries, the Netherlands). While the public sector share of GNP has remained constant in the last decade in Germany, in Sweden it has been reduced by 19, in Finland by 21, in the Netherlands by 13 and in Denmark by 10 percent. In the same period France has reduced non-wage costs and thereby eased the burden on labor. Since then the French economy has grown by as much as one percentage point faster than the German economy.

The pressure from Eastern Europe is not the reason for Agenda 2010 and the Lisbon Strategy, but it is a factor in these related schemes. The core aspect of the Lisbon Strategy is the modernization of the tax and social welfare systems with the goal of stimulating the growth of jobs. (The aim is to raise the employment rate in the EU by

10 percentage points by 2010.) On the supply side, knowledge-based growth is to be increased by reducing taxes on earnings and on physical and human capital. On the demand side a reduction of the tax burden on households is meant to contribute to increased net wages and—after a reform of the social insurance systems—to diminishing non-wage costs to create more jobs.

While the strategic decision for reforms has found general approval, the discussion about the appropriate economic policies has not yet been concluded. Critics warn of cuts in the income of benefit recipients and thus of a procyclical effect of the reforms. In response, it must be argued that in the international competition of investment locations, the German economy is facing considerable pressure, also from the new EU members. They, for example, are able to attract capital from Europe and abroad with lower corporate taxes. Germany may still have, in terms of EU-15 standards, a higher than average savings–income ratio, but approximately 2% of its aggregate savings is invested in foreign countries—to the detriment of growth in Germany itself. Another part of savings has, for some time now, been financing the budget deficits of the federal government, the federal states and the municipalities. In 2003 only the remaining 18.1% was available in the form of loans and capital and other investments. Not only is the investment–income rate the lowest in the EU; for years now investments have not sufficed to improve the labor market situation.

Against this backdrop, the pressure to accept more reforms arising from eastward EU extension has contributed to an enhancement of Germany as an investment location. Exaggerated fear of Eastern Europe is an inappropriate reaction: With the increase in productivity and income levels in the accession countries their attractiveness as low wage havens will disappear and their image as unfair competitors will weaken. The reforms in Germany must continue, however, so that the country does not fall behind in the international competition for investment capital. Of less importance in this respect is the absolute reduction of taxes, as Germany falls in the middle range with respect to this indicator. What is more important is a restructuring of the tax burden with a view to reducing direct taxes and stimulating investment. Investment-friendly conditions will contribute to the further development of capital stock per employee and thus to an increase in productivity and wealth.

© Stiftung Wissenschaft und Politik, 2004
All rights reserved

SWP
Stiftung Wissenschaft und Politik
German Institute for International and Security Affairs

Ludwigkirchplatz 3−4
10719 Berlin
Telephone +49 30 880 07-0
Fax +49 30 880 07-100
www.swp-berlin.org
swp@swp-berlin.org