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EU Extension to the East and Exporting Jobs

Tax harmonization may hurt more and benefit less

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The recent accession of eight East European economies to the EU gave the everlasting discussion in Germany about job exports to low cost countries a new boost. What critics overlook is that since 1990 two regions have been integrating that strongly differ in their capital endowments and productivity levels. The result is, among other things, a slight reorientation of German capital exports towards the new entrants. This should be accepted, not prevented by means of tax harmonization, which would reduce the rate of growth in the new member states. This would simply increase the cost to the West, in the form of higher transfers.

As the fourth EU extension approached, fears emerged in Germany that the economy would be adversely affected. The media and politicians continue pointing vociferously to the possibility of a massive outflow of jobs to the low-cost eastern part of the EU, while the German economy is weak and the unemployment rate exceeds 10 percent. Not only do the Poles, Czechs, Slovaks, and Balts lure western firms to set up factories in their countries. They also receive subsidies and financial support from West European nations with high taxation, which is deemed unjust.

Such fears appear exaggerated, however, if one bears in mind that capital is always looking for the best investment opportunity. That is why it flows between industries and regions and crosses national borders. The ancient Phoenicians lent money to other Mediterranean colonies, the bank of the Fuggers in the southern German city of Augsburg extended credit to the Austrian Emperor, and in the 19th century Britain became a net lender to the world. Germany, too, benefited by importing foreign capital. After World War II it received financial assistance under the Marshall Plan, which enabled it to restore its severely degraded capital stock quickly. Moreover, as the “poor neighbor” shortly after the war, West Germany boasted low labor costs combined with moderate taxation and a fixed exchange rate of the Deutschmark. Thus, on the one hand, the country benefited from foreign financial support, and, on the other hand, from favorable local conditions for investment. Both boosted the economy in general, and exports in particular, and millions of jobs were created.

More than half a century later, relations between the eastern and western parts of the EU are remarkably parallel. Once again poor nations accede to a rich region, and concerns are raised about "unpatriotic" entrepreneurs moving jobs to the east and aggravating the situation in the labor market. What critics tend to overlook is that May 1, 2004 is not a turning point, but only a political event occurring against the backdrop of a deeper economic process dating back to the early nineties. The economic integration of these two differently developed and structured regions – East Central Europe and the EU 15 – commenced then, in the wake of the collapse of the planned economy. Presumably, the heftiest adjustment shocks took place shortly afterwards. Some of the most visible effects are the fivefold rise in merchandise trade between Germany and the East European emerging markets, and a tenfold increase in German direct investment in these countries. However, labor cost hikes and the implementation of EU's tax-breaks limits for investors in Eastern Europe have caused the new partners to lose luster: In 2003 Hungary, the Czech Republic, Slovakia and Slovenia suffered a heavy decline in foreign direct investment inflows, and the trend is likely to be towards less, not more, job imports after accession.

Nevertheless, the adjustment shock reflects a welcomed East-West integration, since it may produce welfare gains by restructuring the entire EU economy. Centerpiece of the process is specialization, i.e., partners concentrate on goods they can produce by utilizing their comparative advantages, and thus raising productivity and income. To converge faster, the Eastern Europeans need additional investment to built up their capital stocks, which are still low. This money is available on the common EU (and international) capital market, where investors search for higher returns in places other than the relatively capital abundant Western EU. Naturally, the West-East capital flow was greatest at the commencement of the integration process. Later, the smaller the capital-per-worker gap becomes, the smaller the return margins become as well, and "job export" to the East will flatten out. The formal EU accession of the East Central European nations does not alter this process, because in general all of the barriers to trade and investment have already been removed. However, the net creation of jobs in the new partner countries by Western investment will fade, or even reverse, once the income gap has been closed.

Capital export (inter alia in the form of foreign direct investment, FDI) also reflects a nation's specific foreign trade and current account position. Germany's export-oriented economy frequently reports huge trade and current account surpluses (in 2003 roughly six and 2.4 percent of GDP respectively). The mirror image of such a net goods and services export position is usually capital export. It moves traditionally to the United States and other major trade partners, and, recently, to Eastern Europe. The destination depends on the net return, which itself depends on specific macroeconomic conditions, such as exchange rate regimes, tax policies, and incentives offered by the authorities. Before deciding to invest, companies carefully consider all of the pros and cons. Even patriotic firms must take local conditions "as is". They cannot alter them, because they are on the macro level. Yet this same applies to the eastern partners too: Later they may even become net job exporters to Germany and Western Europe, as this is the case among nations with similar level of wealth.

It is important to avoid overstating the degree to which the domestic economy is being hurt by the current capital outflows. Between 1990 and 2003 Germany accumulated gross direct investment in the eight accession partners of some 45 billion Euros, and at its peak between 1999 and 2002 the outflow fluctuated between 6 and 7 billion Euros per year. This translates into a meager 1.5 percent of the overall German gross capital investment, and it would be

an exaggeration to blame the current woes of the economy on the integration with the East-EU. It is fair to admit that German direct investment created jobs in the East – even possibly at the expense of Germany's labor market. Yet it is also true that investment abroad will create income in the form of net profit and other return to capital, which may be higher than in the case of domestic investment.

The new entrants as a low tax and a high subsidy region

The new members are less wealthy relative to the average per capita income of the nations that make up the EU-15 than Portugal, Greece, and Spain were in the mid-eighties. Their GDP per capita in 1986, as the European Community's extension to the Club-Med was accomplished, was 55.2, 62.9, and 71.8 percent of the average, respectively. Currently, the most wealthy, as well as the least developed East European entrants, report a larger gap (table).

Per capita income of the new members at PPP*, percent of the EU-15 average in 2003

Country	*GDP per capita*	*Percent of EU average*
Slovenia	18,000	67.7
Czech Republic	15,300	57.5
Hungary	13,300	50.0
Slovakia	12,200	45.9
Estonia	10,900	41.0
Poland	9,500	35.7
Lithuania	8,400	31.6
Latvia	8,300	31.2
EU average	26,600	100.0

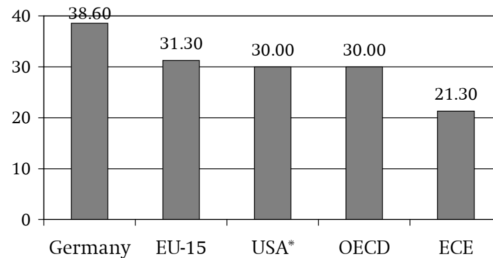
PPP: US Dollars Purchasing Power Parity.
Source: Wold Bank.

To catch up with the per capita income of the EU-15 will require growth rates at least three percentage points above the long run average of the old members. Yet the recent growth performance of the new partners have been contradictory: Immediately after escaping the planned system their economies started to expand at a rate up to 6 percent p.a.. But as of the end of the nineties the pace slowed significantly to less than 2 percentage points above the EU-15 growth rate. This reflects foregone wealth and standard of living, since one percentage point higher growth cuts the catch up period by almost 20 years.

Growth is generated by demand expansion, which in turn depends on national and policy related preconditions in any country. Nations with small savings rates and high income tax rates tend to grow at a slow pace. That is why capital import, foremost in the form of foreign direct investment, will add to the national saving rate of the East European economies and accelerate their growth – to the satisfaction of the entire EU. Evidence suggests that otherwise these poor nations would lag behind for decades, causing frustration with integration and stirring an Anti-European mood. Low income tax rates, as they prevail now in the region, facilitate higher growth rates and help to avoid such tendencies.

By West European standards the new members are indeed a low tax region. Corporate tax rates in the region are far lower than in Germany, or in other western economies (diagram, p. 4). Although Germany and other old EU members are struggling to reduce their tax burdens to avoid capital flight to low tax regions, the East Europeans have been quick to reduce tax rates even more. They continue to lower taxes significantly: Poland cut rates on January 1, 2004, to 19 percent, the Czech Republic is about to reduce them from now 28 percent at this time to 24 percent in 2006, and Estonia already announced a new tax regime with a flat corporate tax rate of only 15 percent, etc. Moreover, the tax system in many countries is straightforward and streamlined, and thus easier to deal with. For instance, Slovakia recently introduced an unified corporate, personal income, and value added tax rate of just 19 percent.

Corporate tax rates in East Central Europe (ECE), and western economies in 2004 (percent)



* Effective rate. Sources: OECD; (German) Federal Ministry of Finance.

In spite of cutting taxes to become more competitive for foreign (direct) investment, Eastern Europe as a whole remains a low income area. It is eligible for agricultural subsidies and structural support from Brussels, financed mostly by nations with a heavy tax burden like Germany, the Netherlands, Sweden, etc. Arguably, these western partners consider the combination of a low tax a policy on the one hand, and money transfers from the rich nations on the other, as unjust. Criticism is increasingly vociferous in Berlin and other capitals, yet critics tend to miss two facts:

First, most subsidies do not replace financing from national sources. The opposite is true: Starting in 2004, the new countries will receive direct payments in agriculture at 25 percent of the level the old members receive, and will reach parity with their competitors in Western EU only in 2013. Additional funding from national sources to top up the subsidies from Brussels is permitted, but even so farmers in Eastern Europe (except in Slovenia, which may match the western support level soon) will receive less than those in the Western EU.

As for structural policy, funding of structural actions follows the principal of co-financing. So, member states are not allowed to substitute the domestic funding of development programs by money transfers coming from Brussels. Further, the overall transfer amount each EU country receives for structural actions is capped at 4 percent of its gross domestic product. Yet even this ceiling may hardly be exhausted, as experience of the past teaches. Because of application procedures and bureaucratic obstacles, as well as typically short deadlines for submission of properly filled project forms, some of the amount available is never applied for. As a thumbnail rule, the new members may absorb merely two thirds to three quarters of the money, which reduces the nominal cap even further to less than 4 percent of their output.

Second, if the new entrants were to raise taxes to fund more projects on their own, the success would be short lasting. The greater tax burden would weaken the economy and slow the growth of output, slowing the convergence of the East-West income levels even further. However, lasting poverty in the eastern part of the EU would require the West to transfer money to the poor members indefinitely at the expense of its own growth prospect. Ironically, it was Germany that made an instructive experience with the integration of the former East Germany. Fourteen years later it becomes clear that despite more than one trillion Euros channeled there, the new federal states are still struggling to achieve strong sustained growth. Here the conclusion should be that high tax, but low-income regions end up with more, not less, subsidies – at the expense of the entire economy. Often they suffer a shrinking tax base, since tax revenues are conversely related to the tax rate.

Moreover, especially at the beginning of membership, the new partners will enjoy relatively low support from Brussels. The planned net transfers between 2004 and 2006 total 25 billion Euros, which is merely eight percent of EU budget expenditures. This is more than the contribution of the region to the EU's GDP of five percent, but less than its population share of 20 percent. Admittedly, a spending cut of eight billion in the western EU will cause output growth here to slow. At the same time growth will

accelerate in Eastern Europe with a beneficial effect to the western partners.

Tax harmonization will hardly cure Germany's problem of sluggish growth, and putting an additional burden on the fragile economies of Eastern Europe will not shrink Germany's high unemployment rate. Instead of calling for a correction, or even a reversal, of the growth-friendly policies in the East, it would be better to reconsider where Germany's net contribution to the EU budget can be reduced. The greatest potential to cut spending hides within the common agricultural policy (CAP). Also, fortunately, because of the worrying shape of the new *Länder*, where unemployment rates match or exceed those in neighboring Poland, the Czech Republic, and Hungary, Berlin possesses a convincing justification to claim more support from Brussels, which may partly make up the capital outflow to the East.