LOMBARD STREET RESEARCH

Monthly Economic Review

No. 116, February 1999

Contents Page No.

Gerrard Group PLC

Gerrard & King Limited
Cannon Bridge,
25 Dowgate Hill,
London, EC4R 2GN
Tel: 0171 337 2800
Fax: 0171 337 2801
e-mail: enquiry@gerrard.com

GNI Limited
Cannon Bridge,
25 Dowgate Hill,
London EC4R 2GN
Tel: 0171 337 3500
Tlx: 884862
Fax: 0171 337 3501
e-mail: enquiry@gni.co.uk
www.gni.co.uk

Lombard Street Research Ltd.
Cannon Bridge,
25 Dowgate Hill,
London, EC4R 2GN
Tel: 0171 337 2975
Fax: 0171 337 2999
e-mail: lsr@lombard-st.co.uk
www.lombard-st.co.uk

Greig Middleton & Co. Limited
30 Lombard Street,
London, EC3V 9EN
Tel: 0171 655 4000
Fax: 0171 655 4321
e-mail: enquiries@greigm.co.uk
www.greigm.co.uk

Greig Middleton Financial Services Limited
30 Lombard Street,
London, EC3V 9EN
Tel: 0171 655 4000
Fax: 0171 655 4343

Of employment, interest and money

Can an economy with rising employment be in a recession?

The UK is supposed to be in a recession, but employment is rising

Something has gone wrong with the British economy. Everyone - or, at any rate, every economic commentator - agrees that the British economy is in or close to a recession. If the word "recession" has any definite meaning, it is that output is falling. As the normal condition of the UK economy is for output to be rising and employment to be broadly stable, a recession ought therefore to be associated with declining output and even more rapidly declining employment. But nothing of the sort is happening. On the contrary, recent data show that employment is increasing. The Labour Force Survey for the September-to-November period last year put UK employment at 27.3m., up almost 100,000 on three months earlier and almost 300,000 up on the same period in 1997.

In the last two recessions employment fell by over 60,000 a month

The conjunction of supposed "recession" with rising employment is odd. One explanation is simply that productivity performance in late 1998 was appalling. A few quarters of flat productivity are indeed quite common when the economy slows down. However, in a genuine recession poor productivity does not stop employment going down. In the last recession - from mid-1990 to mid-1992 - the workforce in employment tumbled from 27.2m. to 25.7m., with an average monthly employment decline of 60,700; in the previous recession - from the end of 1979 to the middle of 1981 - it slid from 25.6m. to 24.5m. and the average monthly rate of decline was 62,300. Although business surveys today indicate lay-offs and redundancies in some sectors, the labour market is much more buoyant than in these two episodes.

Business surveys may have missed structural changes to the economy

What is going on? Of course, the Government has amended tax and benefit arrangements in order to encourage people to come back to work. But the Institute of Fiscal Affairs has estimated that the new Working Families Tax Credit will increase the number of people participating in the labour market by only between 10,000 and 45,000. As the Bank of England notes in its latest *Inflation Report*, "numbers of this magnitude are unlikely materially to affect whole-economy labour supply". A more intriguing possibility is that all the talk about recession is wrong. This would be surprising, in view of the weight of evidence from business surveys and a number of output series (such as steel production) which show that many companies have had a tough time in recent months. But business surveys and traditional output measures may have overlooked the importance of structural changes to the economy, including the booms in multimedia, internet-based services and computer software. If the employment numbers are right and the consensus forecasters are wrong, the Bank of England should continue to take note of rather high money growth and hesitate to cut base rates under 5% in the near future.

and overstate the case for lower interest rates

Professor Tim Congdon — 16th February, 1999

Summary of paper on

"How much European tax harmonization raise British taxes?"

Purpose of the paper

Tax harmonization, like the single currency, is an integral part of European economic and monetary union (EMU). This research paper tries to answer the question, "if the UK participated fully in EMU, how much and in what ways would its tax burden increase?".

Main points

* **The UK's tax-to-GDP ratio would have to rise by one-sixth to bring it into line with the tax-to-GDP ratio in the rest of the EU; it would have to rise by over 20% if government spending in the UK, relative to GDP, were to rise to the EU level. (See pp. 4 - 5.)**

* **As the ratio of government spending to GDP in the EU has been on a long-run upward trend, the future increase in UK taxation would be larger. It might be as much as a third. (See p. 6.)**

* **Contrary to a well-established stereotype, the burden of corporate tax is not low in the UK by European standards. (See p. 8.) In fact, the ratio of company tax to GDP is rather high by EU standards.**

* **The difference in the tax burden between the UK and the EU is explained entirely by social security contributions, which are about 6% lower (as a share of GDP) in the UK. (See p. 9.) This contrast is largely explained by the UK's distinctive pension arrangements, with extensive funded coverage by the private sector.**

* **If full-scale tax harmonization were to proceed across the EU, a possible implication would be a special welfare levy in order to equalize labour costs. This would cause a further shift to low-productivity work in the informal sectors of all European economies, and reduce employment, output and living standards in the UK. (See p. 12.)**

This research paper was written by Professor Tim Congdon. It formed the basis for a public lecture to the Politeia think-tank on 26th January and will appear as a Politeia pamphlet later this year.

How much would European tax harmonization raise British taxes?

UK tax burden would rise by about 20%, with more to follow

Two aspects of EMU are related,

Tax harmonization and the single currency are integral to European economic and monetary union (EMU). About that there can be no doubt. Dozens of speeches have been given by European heads of state and European Commissioners emphasizing the role of both developments in the process of integration that is now under way. It is therefore reasonable to analyze the consequences of European tax harmonization for the UK as if such harmonization would result from the adoption of the single currency.

even though in principle they could be separate

This is not to deny that, in principle, tax harmonization and the single currency could be separate and unrelated. It would be possible for the nations of Euroland to have a single monetary unit of account and different tax levels. After all, the states of the USA have a single currency, but widely divergent state and local taxation. It would also be possible for the nations of Euroland to have distinct currencies and similar tax levels and, indeed, much the same tax structure. However, in the real world of the late 1990s tax harmonization and the single currency are joint and related aspects of the integrationist project. The close relationship between them was noted by the Commissioner for EMU, Mr. Thibault de Silguy, in an interview with *The Sunday Telegraph* in December last year. He ventured the hope that the single currency would strengthen the links between the different nations' financial markets and then judged that, "For integrated financial markets to work we must harmonize taxes". Pressure on the UK and Luxembourg to introduce withholding tax on financial securities is the most topical and urgent expression of the harmonization drive, but Mr. de Silguy made clear that - as far as he was concerned - this would be only the beginning. In his words, "Harmonization of corporate taxes is the next item on the agenda."

Mr. de Silguy's view

Once tax structures are made similar, pressure for the same tax rates develops

Despite the abundance of statements linking tax harmonization and the single currency project, Britain's Prime Minister, Mr. Blair, has insisted that one does not imply the other. Both he and Mr. Gordon Brown, the Chancellor of the Exchequer, have said that the UK retains its veto in tax matters. They might appeal to the wording of the Presidency Conclusions which emerged from the meeting of the European Council in Vienna on 11th and 12th December last year. Paragraph 21 welcomed "reinforced tax policy co-operation", but accepted that such co-operation "is not aiming at uniform tax rates and is not inconsistent with fair tax competition". Superficially, Mr. Blair is right to assert that tax harmonization would not entail the same tax rates, even though it might involve convergent tax structures. But this does not really wash. The Presidency Conclusions also state that Europe's leaders oppose "harmful tax competition", "continuing distortions to the single market" and "excessive losses of tax revenue". In other words, once the systems of taxation had become harmonized, pressure for greater uniformity of rates would follow in order to prevent so-called "distortions" and "excessive" revenue losses in high-tax countries.

Example of value added tax, with pressure for same tax structure and rate

The inevitability of a drive towards similar tax rates is shown by the Commission's approach to value added tax, where 42% of the receipts are already the Union's "own resources". The Commission has constantly worked for the harmonization of both the system of assessing and collecting VAT across the EU, and for the rate at which the tax is levied. Moreover, even if harmonization were to stop with tax structures and to leave tax rates at national discretion, it must not be overlooked that significant costs might be incurred by taxpayers even if the tax rates were negligible and revenues trifling. The imposition of VAT on UK transactions in commercial property, of a withholding tax on interest from securities issued in the UK and of the *droit de suite* on sales of works of art by the London auction houses may generate tiny amounts of revenue, but they all imply significant compliance and monitoring costs for the industries affected.

Key questions to be answered from OECD data

In short, tax harmonization may be interpreted as an explicit and deliberate by-product of the introduction of the single currency. The UK is undoubtedly regarded by other European states as the source of "harmful tax competition". The central questions for British policy-makers become "how much would UK tax levels have to rise?", "which taxes would be increased most?" and "what would be the economic effects of such increases?". Possible answers to these questions emerge in the the following review of the tax position of the UK and its European partners, but an important proviso needs to be made at the outset. The main source of information for the charts is the latest issue of the OECD's publication *Revenue Statistics*. The OECD has attributed revenue to various categories, such as "corporate taxes", "property taxes" and so on, while the data are not entirely up-to-date. The categorization is necessarily arbitrary, while some statistical obsolescence is inevitable with any data source. The conclusions of this study therefore depend to some extent on the OECD's approach to compiling the numbers.

If tax in UK rose to the average in the rest of the EU, it would go up about a sixth

On the first question - about the potential rise in the UK's overall tax level - the answer is fairly clear. In 1996 tax was 36% of GDP in the UK and almost 42% in the rest of the European Union. Assuming that harmonization were to the average in the rest of the European Union (and not to the average of the EU as a whole), the UK's tax burden would have to rise by about a sixth. That would of course be most unwelcome to the UK's taxpayers, but it is not the end of the bad news. In the long run taxes must be related to government expenditure. In the 1990s the difference between the ratio of government expenditure to GDP in the UK and the rest of Europe has been and remains greater than the difference between the ratio of tax to GDP. Of course, the divergence between the tax burden and the importance of the state in the economy largely reflects differences in budget deficits. In the last few years the ratio of the budget deficit to GDP has been lower in the UK than in the rest of Europe and, indeed, at the moment the UK has a budget surplus.

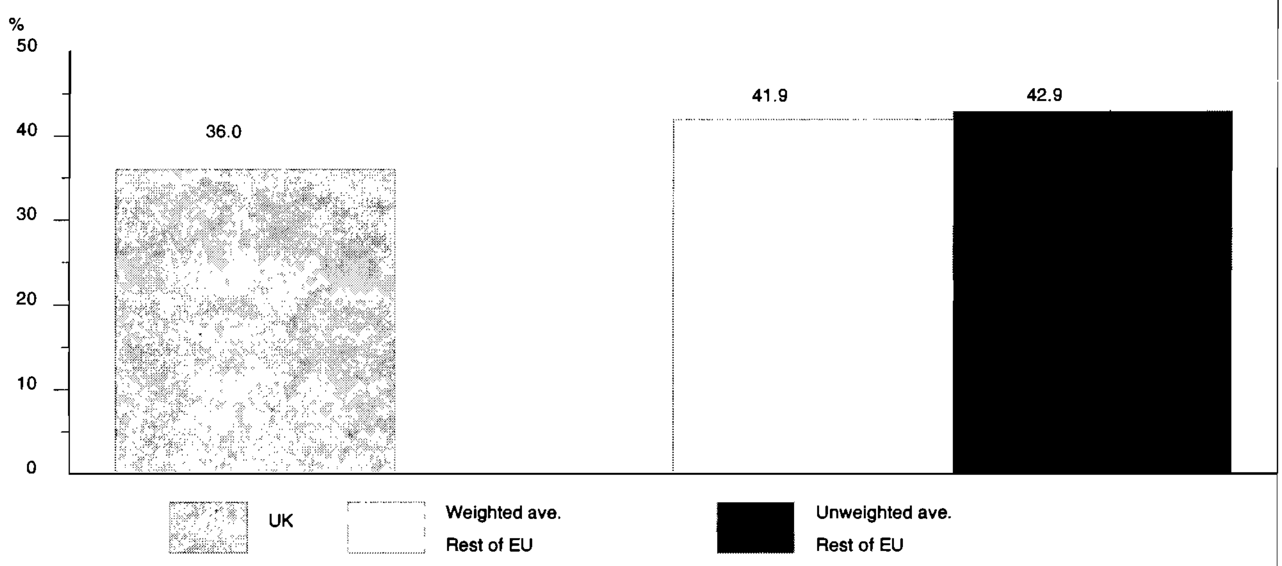
Difference in ratio of government spending to GDP greater than difference in ratio of tax to GDP, implying a tax rise of 20%-25%

In 1996 government spending was 41.8% of GDP in the UK, but 49.6% in the EU as a whole and somewhat more than 49.6% in the EU excluding the UK. So the burden of government spending was about 20% higher in the rest of the EU than in the UK. The OECD projects that in 1999 the ratio of government spending to GDP will be 38.9% in the UK, but 47.0% in the EU as a whole. The burden of government spending to GDP now is therefore almost 25% higher in the rest of the EU than in the UK. It follows that - if the aim were to harmonize both tax levels and the ratio of the budget deficit to GDP - taxes in the UK would have to rise by between a fifth and a quarter. As the objective of the Maastricht Treaty is openly to secure similar budget deficits (relative to GDP) across the member countries of the single currency zone, this calculation seems more appropriate than that based on 1996 tax burdens alone. The precise figure depends on how far the 1999 projections are viewed as cyclical and temporary, and so put the UK in an unsustainably favourable light. Further, enthusiasts for European integration might claim that the large expenditure increases announced by the present UK Government for the last three years of the current Parliament will narrow the gap between the UK and the rest of Europe.

An extrapolation from past trends suggests that - by 2011 - the tax rise for the UK would be near a third

This may or may not be so. It needs to be remembered that Europe is dominated at present by left-wing governments, all of which have plans for extra expenditure. Arguably, a neutral procedure is to examine the past behaviour of tax as a share of GDP in the UK and the rest of Europe, and to see whether any long-established trends can be identified. If they can be identified, the trends may reasonably be extrapolated. Taking the OECD data as the source, a simple time trend was estimated back to 1965 for tax as a share of GDP in the UK and the EU15. The equation for the EU15 found a significant positive coefficient on the trend term, whereas that in the UK equation was not significant.

Tax in UK and rest of EU as a % of GDP - 1996



Source: OECD

So, in a forward projection, it is fair to suggest that the ratio of tax to GDP will continue to rise in the EU15, but not in the UK. The chart on p.7 shows the results of this exercise. By 2011 (i.e., 15 years from 1997, the last year for which actual figures are prepared by the OECD) tax is over 50% of GDP in the EU15, but under 40% in the UK. When allowance is made for the UK itself accounting for about a seventh of EU output, the implication is that - little more than a decade from now - the UK tax burden would have to rise by over a third to equalize taxes in the UK and the rest of Europe.

Counter-claims must be based on research

This result may come as a shock to supporters of the UK's participation in the single currency project. It certainly goes a long way to explain our neighbours' interest in preventing so-called "harmful tax competition". Euro-philes might object that the statistical extrapolation is naive and flimsy; they might claim that the obvious political importance of the conclusion is out of balance with the limitations and simplicity of the analytical method. Fair enough, but this does not excuse them from conducting their own work on prospects for public expenditure within Europe. Of course, the UK's advantage could be squandered by policy mistakes. If the Labour Government's intention is a large expansion of public expenditure and a sharp increase in taxation in order to make the UK comparable with the rest of Europe, its leaders might be more forthcoming on the details.

Research by supranational organizations confirms UK's favourable position

As for our neighbours, big changes in the direction of public expenditure and fiscal policy are implausible. In fact studies have been carried out by such organizations as the OECD, the International Monetary Fund, the World Bank and the International Labour Office on future trends in public spending across Europe.(1) They arrive at much the same verdict as the one suggested here, that the gap between the tax burden in the UK and the rest of Europe is likely to widen, not narrow, over the next few decades. This widening is readily explained as the joint product of the age-ing of Europe's populations and the UK's distinctive reliance on substantial private provision for pension funding. Contrary to much propaganda, there is little evidence of a worthwhile shift across the continent of Europe towards so-called "Anglo-American" styles of pension funding.

Tax rise for UK of between a sixth and a third implied by European tax harmonization

To summarize the answer to the first question, the increase in UK taxation implied by European tax harmonization is at least a sixth and, more likely, it is between a fifth and a quarter. Moreover, the initial jump in taxes would be only the start. Over the next 15 years or so, the increase compared with current levels might be as much as a third. This increase - which is to understood in terms of the ratio of tax to GDP - would occur as the result of the UK's alignment with a European average boosted by neighbouring governments' long-term promises on pensions and social security.

Where would the extra burden fall?

It is time to consider the second question. Where would this extra burden fall? What kind of taxes would be raised? The stated purpose of tax harmonization is to end alleged distortions due to differential tax incidence on essentially the same economic activities. Presumably this end would be achieved if much the same revenue (or revenue-to-GDP ratio) were to arise from particular kinds of tax in all EU countries. If so, one way of answering the question is to compare the amounts of revenue raised at present by different types of tax in the UK and the rest of the EU, on the assumption that tax harmonization would in future move the UK closer towards the EU's existing pattern.

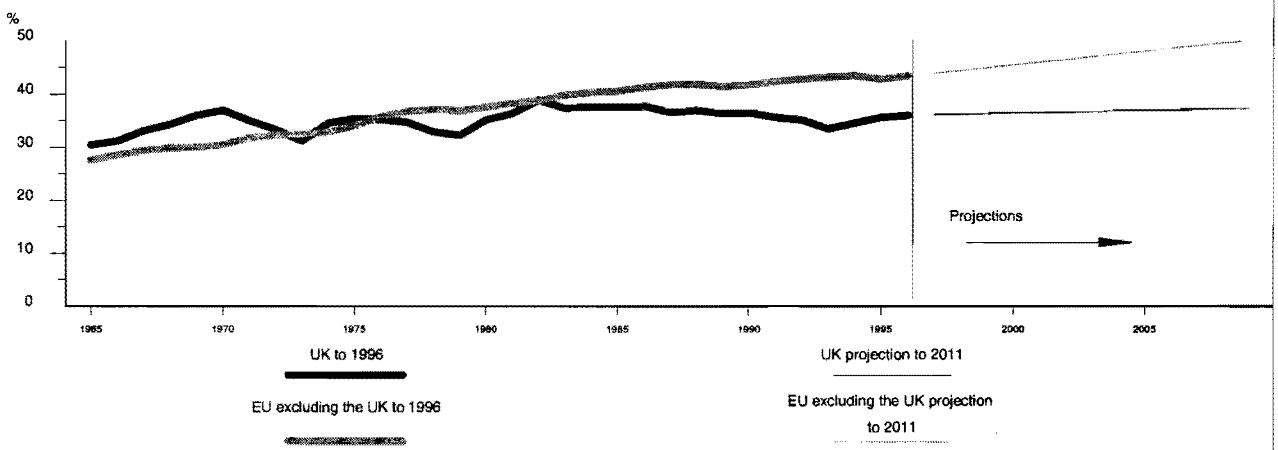
Direct taxes on personal income are lower in the UK than in the rest of Europe, but not much

Much political attention is paid to income tax, because of it is direct, transparent and newsworthy. Taxes on personal income are indeed higher in the EU than in the UK. Whereas in 1996 they represented 11.3% of GDP in the EU on average, in the UK they were 9.3%. As is well-known, tax on particularly high incomes is lower in the UK than in other European countries. The UK's top rate of 40% compares with top rates elsewhere typically above 50%, which may be one reason for the often expressed preferences of European company managements to locate their headquarters and research functions in the UK. However, the 2% difference between the UK and the rest of the EU in the personal-tax-to-GDP ratio is small compared with the contrast in the overall tax level. The major source of difference in the tax burden must lie elsewhere.

Taxes on income from capital and profits are early candidates for harmonization

Europe's leaders have made no secret that they want to target the taxation of income from capital (such as interest and dividends) and corporate taxation. The Vienna meeting of the European Council invited the Commission "to pursue work on the proposals for a Directive on the taxation of savings and for a Directive on interest and royalties". Despite protests from Mr. Blair, Mr. Brown and their Luxembourg counterparts, these Directives are to be ready before the Helsinki meeting of the European Council in December 1999. Again following a recommendation from the Vienna meeting of the European Council, the Commission has started work on a study of company taxation in the EU. As noted earlier, Mr. de Silguy has been outspoken in urging that harmonization of corporate taxation be the next step after the harmonization of withholding taxes.

Tax in UK and the EU (excluding the UK) as a % of GDP with projections for 1997 to 2011



Source: OECD and Lombard Street Research estimates

UK has low rate of tax on company profits, but actual receipts are high by European standards

Apparently, the advocates of increased European integration believe that the UK has a lower level of company taxation than other EU countries, while they see harmonization as raising UK corporate taxes towards the European norm. The truth is more complex. The standard rate of corporation tax varies widely across the EU. According to Ernst & Young, the lowest rates are in Sweden and Finland, and are under 30%. The UK comes next with 31%, but it is not particularly abnormal. Several countries have rates between 30% and 40%, and only two (Germany and Italy) are above 50%. A starkly different message is given by the OECD statistics on actual revenues from corporate taxation. Expressed as a ratio of GDP, company taxation is higher in the UK than in the EU as a whole. Indeed, it is above the level in 11 other EU countries. According to the OECD, the country with the lowest burden of company taxation in the EU is Germany and the second-lowest is France.

Adjustment needed for depreciation rules and investment allowances

This contradiction of the stereotypes may be surprising. It emphasizes the importance of careful attention both to the definition of terms and to the detailed structure of tax at the national level. The key point here is that Germany, France and Italy may ostensibly have heavy corporate tax, but in reality they do not. The high rate of corporation tax is more than offset by generous depreciation rules and investment allowances; the effective rate of company taxation is much less than the standard rate of tax on company profits. Paradoxically, the harmonization of company taxation might lower the taxes paid in the UK on company profits. However, this should not be understood as a recommendation that the UK participates in the process. Theoretical analysis and ample empirical evidence suggest that a low standard rate accompanied by sensible depreciation rules and minimal investment allowances is more conducive to economic efficiency than a high rate balanced by a multitude of special concessions.

Tax competition between nations has *not* reduced burden of company taxation

The facts - as opposed to the conventional wisdom - show that the UK is not a tax haven for companies. Despite all the accusations of "harmful tax competition" directed at the UK, and despite the widely-held view that tax competition between nations is concentrated in the corporate sphere, British companies pay taxes amounting to a higher ratio of GDP than their European equivalents. Even more unexpected is that the statistics do not show international tax competition leading to a long-term decline in the ratio of taxes on corporate income to GDP. The ratio of taxes to corporate income is highly cyclical, due to the marked cyclicality of profits themselves, but the underlying trend over the last 30 years has been for it to increase both in the UK and in the nations of the EU taken together.

What about other taxes?,

So taxes on personal income are only 2% lower relative to GDP in the UK than in the EU as a whole and taxes on corporate income are slightly higher. Where, then, is the big difference in the tax burden? Two other OECD's categories are taxes on "goods and services" (i.e., indirect taxation) and taxes on property. Do they go some way to bridging the gap between the UK and other European nations?

such as indirect taxes and taxes on property

The answer is a clear "no". In 1996 indirect taxes in the UK yielded revenue amounting to 12.7% of GDP, much the same as the EU average of 13.0%. The UK exempts food and children's clothing from VAT (unlike the rest of the EU), whereas its excise duties are more important revenue raisers than their equivalents in neighbouring countries. However, despite the differences in structure, the UK's overall indirect tax burden is close to the European norm. Taxes on property are very miscellaneous. In the UK the most important is the council tax, whereas some European countries have a proliferation of minor wealth taxes as well as local property taxes. At any rate, the OECD estimates that taxes on property raise 3.8% of GDP compared with a European average of 1.8% of GDP.

Difference in aggregate tax burden can be explained entirely by lower social security contributions,

So where is the big difference in the tax burden? The aggregate tax take is certainly lower in the UK than in its neighbours, but a survey of taxes on personal and corporate income, indirect taxation and taxes of property has failed to identify any major divergences in the amount of revenue (relative to GDP) raised from any of them. Only one important type of levy remains, social security contributions. It turns out that virtually all of the difference in the aggregate tax burden between the UK and the rest of Europe is explained by this one item. In 1996 social security contributions amounted to 6.2% of GDP in the UK, which was almost half the EU average of 12.2%. The 6% gap here was virtually identical to that between a total tax take in the UK of 36.0% of GDP and in the EU of 42.4% of GDP.

but are such contributions really "taxes"?

A case could be made that social security contributions are not "taxes" in the usually understood sense. In the UK - as in other European countries - they are credited to an account which, by statute, is distinct and separate from the main central government accounts. The resulting "National Insurance Fund" is intended to cover benefit payments without affecting the rest of the Government's finances. Indeed, every five years an actuarial appraisal is made of the National Insurance Fund's ability to meet future claims.(2) The UK's national insurance contributions could be regarded as analogous to life insurance premiums within the private sector and not really as taxes at all.

Yes, they are really taxes

The counter-argument is that the link between any one individual's contributions and benefits is tenuous, as well as being opaque to most people. The Government has the power both to raise NI contributions while leaving benefits unchanged and to boost benefits without accompanying it by an increase in contributions. In the last 20 years the Government has often used this power without much regard to actuarial solvency. Moreover, the pattern in the UK for many years has been a decline in the relative importance of contributory benefits, which are paid from the National Insurance Fund and notionally related to contributions. Non-contributory benefits, paid by general taxation, have gained ground and are doing part of the job once assigned to contributory benefits. In short, the boundaries between contributory and non-contributory benefits, and between the National Insurance Fund and other government accounts, are arbitrary and administrative, not substantive. "Social security contributions" can be seen as a form of taxation.

UK's social security costs declining - relative to rest of Europe - since the 1970s

The chart below shows the evolution of social security contributions over the 30 years to 1995. Even in the 1960s they were lower, as a share of GDP, in the UK than in the rest of Europe, but the difference was little more than 1% of GDP. Over the following decade social security contributions rose - again relative to GDP - in both the UK and the EU15. It was in the 20 years from 1975 that the divergence became marked. In the UK social security contributions remained steady at about 6% of GDP, while in the EU15 they climbed from under 10% of GDP to over 12% of GDP. Perhaps the key event differentiating the UK from other European countries was the decision in 1981 to base future increases in the state pension on prices, not earnings. The implication was that - with economic growth, rising real earnings and stable demography - the ratio of state-financed pension spending (and so of national insurance contributions) to GDP would fall. This adjustment, combined with the Conservative Government's related measures to phase out the State Earnings- Related Pension Scheme (SERPS), signalled a large future increase in reliance on private pension provision.

and gap is now substantial,

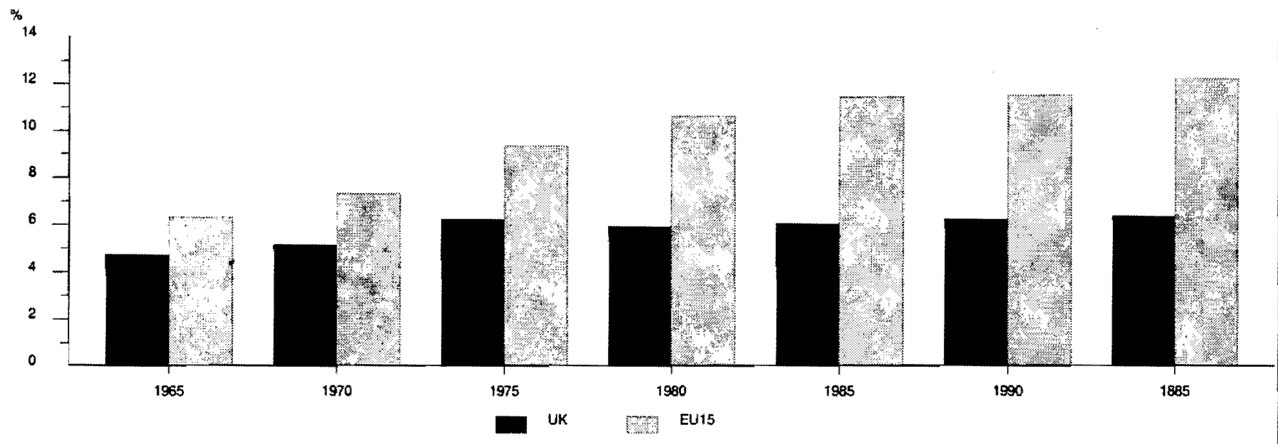
Now - almost 20 years after the changes - the benefits to the UK in terms of lower social security contributions, and so in lower labour costs, have become apparent. Employers' social security contributions are only 3.4% of GDP in the UK, while the unweighted average for the EU15 is more than twice as high at 6.9%. (The weighted average for the EU excluding the UK might be nearer 8%. The EU average includes a figure for Denmark of 0.3%, but this arises because of an anomaly in the Danish arrangements whereby social security taxes are categorized with indirect taxes.) In France employers' social security contributions are 12.2% of GDP, while in Germany and Italy they are 7.8% and 10.3% of GDP respectively. The difference between the UK and other European countries has undoubtedly affected behaviour. High social security contributions discourage employment and reduce participation in the labour

affecting behaviour

force. In 1995 the labour force participation ratio for men aged between 55 and

Has the UK competed with low employment taxes, not corporation tax?

Chart shows social security contributions as % of GDP



Source: OECD

59 was 73.7% in the UK, compared with 66.1% in France, 71.6% in Germany and 67.9% in Italy; in the same year the labour force participation ratio for men aged 60 to 64 was 50.1% in the UK, but 28.9% in Italy, 28.5% in Germany and only 17.0% in France.

Growth of low-productivity work to avoid social security costs

Heavy social security costs also cause people to transfer from full-time work as employees; they stimulate the growth of self-employment and of small-scale, part-time, informal employment, where the payment of contributions is administratively a nuisance and may be legally unnecessary. The productivity of self-employed workers and part-timers in the informal sector is far less than in full-time work for large companies. Perhaps not surprisingly, in most European countries the number of people working full-time in the private sector is lower today than it was 20 years ago, while productivity growth has slowed. The UK has suffered from these patterns, but not to the same degree as its neighbours.

Conservatives' tax competition was *not* in the corporate area,

In some ways the crucial role of social security arrangements in explaining the UK's tax advantage is ironic. Decisions taken during the 18 years of Conservative rule to 1997 explain both the lower aggregate tax burden in the UK and the particularly low burden of social security costs. The Conservatives are sometimes criticized for being biassed towards business and profits, at the expense of labour, wages and employment. When EU Commissioners say that harmonization of company taxation is the next priority in the integration project, they may have this image of the UK in mind. Their targets undoubtedly include the UK's 31% standard rate of corporation tax and similarly low standard company tax rates in a few other countries.

but in taxes on employment

But - to repeat - the facts do not conform to the stereotype. Despite the common perception that the UK has manipulated company taxation in order to attract foreign direct investment, the statistics show that UK companies pay more tax on profits - relative to GDP - than companies elsewhere in the EU. The dramatic contrast between the UK's tax structure and the average EU tax structure lies not in the corporate area, but in taxes on employment. The policy reforms in the two decades of Conservative rule were favourable to increased labour force participation and employment, particularly when compared with contemporaneous developments in the rest of the EU.

For the UK tax harmonization would lead to less output and fewer jobs

The final question was, "what would be the effects of tax harmonization on output and jobs?". Assuming that tax harmonization means a move both to a uniform aggregate European tax burden and to a similar structure of taxation, the conclusions of the analysis are straightforward. Incentives for employers to take on workers and for workers to seek employment would be reduced. Further, workers would regard permanent, full-time and high- productivity employment as less worthwhile. Such employment requires full payment of social security contributions, whereas temporary, part-time and low-productivity employment often does not. In short, for the UK the harmonization of its tax system to the European norm implies a big rise in taxes, which in the medium term might be as much as a third; this rise would be concentrated in social security contributions; and its results would be less employment, lower productivity per person and lower national output.

If taxes and deficits are determined by Brussels, so also is state spending

It is difficult to believe that any British politician - whatever his or her party affiliation - could be in favour of these outcomes. Enthusiasts for greater British involvement in European integration might protest that no EU initiative exists either for uniform levels of government spending or for harmonization of social security arrangements; they might therefore insist that pan-European tax harmonization does not necessitate the large increase in the UK's social security contributions indicated by the analysis in this paper. But they cannot escape the connections between tax, deficits and spending. Recent statements from the European Commission and leading European politicians are unquestionably for tax harmonization, including a levelling of tax rates, while the Maastricht Treaty takes away most national discretion on the size of budget deficits. If tax and budget deficits are given, national governments cannot be free to determine the level of expenditure. That is a matter of logic.

Social security may be on a national basis, but an EU-wide welfare levy is conceivable

Similarly, the contention that social security contributions are linked to welfare benefits at a national level, and so cannot be transformed into an EU-wide scheme for welfare provision, is unconvincing. Of course, the wholesale pan-European amalgamation of national social security systems is implausible. But it would not be beyond the wit of the European Commission to propose a European welfare levy, to be applied uniformly to wage costs all over Europe and yet with the proceeds redistributed to high-cost countries. (Indeed, the EU's existing Structural Funds have an openly redistributive purpose. Note also the recent hints of changes to the Common Agricultural Policy, which would reduce support for high-income farmers. The UK has a relatively concentrated farm sector, with more high-income farmers than other EU countries.)

European statesmen plainly opposed to tax competition between nation states

Europe's leaders deserve to be judged by their rhetoric as well as by their actions. Whatever the weaknesses in the single currency project, the rhetoric has in the end led to action. Over the last few years members of the European elite have been forthright in their views about tax and EMU. They have advocated tax harmonization in an increasingly unified European state, not tax competition between sovereign nation states within a European free trade area. Largely because it had almost 20 years of continuous rule by a political party which believed in free market and a reduced economic role for the state, the UK is nowadays a low-tax country by European standards. If it participates in EMU, the UK would become a higher-tax country; if it embraces European integration warmly, it might a generation from now be part of a high-tax region in a world where tax competition between regions is intensifying.

(1) See International Labour Office *From Pyramid to Pillar* (Geneva, 1989), Word Bank *Averting the Old Age Crisis* (Oxford: OUP, 1994) and OECD Policy, *Implications of Ageing Populations* (Paris, 1996).

(2) *National Insurance Fund Long Term Financial Estimates* (London: HMSO, 1995).