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Comment on Hans-Werner Sinn: European integration and the future of the welfare state

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Europe has become more integrated. The movements of capital, labor, goods, and services have gradually become more free. The process continues. There will be a European monetary union soon. This will increase the pressure on national fiscal systems and become a threat to the welfare states. Has the welfare state any future in an integrated Europe? Hans-Werner Sinn's answer is that integration will make it impossible to keep welfare states of the size and the design as we now can find in Europe.

There are several basic reasons why this may be a problem. One reason is that the welfare state may have useful functions to improve the allocation of resources in the economy. This way, the public sector can increase the efficiency of the economy. Another reason is that public redistribution may also increase efficiency. If there is too much fiscal competition, the risk is that the welfare state becomes too small.

I believe that it is important to keep in mind that there are other significant trends. One is that the way people view the world changes. Another is that younger generations have other perspectives than older generations. There is a process one could call *the integration of minds*. This, for example, is reflected in the improvements in foreign-language skills. These trends in the preferences of people are necessary for integration to be accepted.

There are many questions to be addressed when discussing European integration:

1. *Will the integration process go on? Will Europe continue to become more integrated?* Yes, the process will go on. The speed may very well vary, but the long-term direction is clear.

2. *Will integration limit national policies?* Yes. Capital mobility is an especially important factor that limits national policies. In the

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longer run, labor mobility within Europe will probably increase. This will further limit national policies.

3. *Is this a problem?* Not necessarily, it depends on the preferences of the citizens. If the preferences become more similar, then the preferred policies will become more equal. To the extent that there exists market failures, which could be corrected by public policies, it then becomes a question if it is possible to coordinate policy on a European level.

4. *Will there be any room left for national policies?* Yes. And I argue for this through comparisons with the U.S. The U.S. is an example of a large area with a history of a common currency and of free movements of capital, labor, goods, and services within the area. The question is: *Has it been possible to pursue different tax and expenditure policies on state and local levels?*

Table 1 presents evidence that this has been possible. States within the U.S. differ a lot in per capita income. Per capita income in the richest state is twice as high as in the poorest. If we look at per capita state and local expenditure by state, we find that the state with the highest expenditure spends twice as much as the state with the lowest. Spending per pupil in public schools differs by a factor of three between the state that spends the most and the state that spends the least.

We find a similar dispersion for revenue as for expenditure. Per capita state and local revenue by state differ by a factor of two between highest and lowest revenue. Moreover, the tax structure differs considerably among states. Almost half the revenue is raised by property taxes in some states, while hardly any revenue is raised this way in other states.

In some states, general sales taxes give one-fourth of the revenue, in other states there are no general sales taxes. The pattern is similar for individual-income taxes. In some states, there are no individual-income taxes while there are states where up to 25 percent of the revenue comes from individual-income taxes. State gasoline taxes provide another example of the differences in tax structures among states.

Table 1. A comparison of states within the U.S.

Variable	Lowest	Median	Highest	Average
State per capita income, 1993, USD	14,700	19,600	28,000	20,800
State and local government general expenditures per capita by state, 1991, USD	2,700	3,400	5,500	3,600
Current spending per pupil in public elementary and secondary schools, 1992, USD	3,000	5,100	9,300	5,400
State and local government per capita revenue by state, 1991, USD	2,700	3,400	5,300	3,600
State and local general revenue sources by state, 1991				
Property tax, % of revenue	6	17	43	19
General sales tax, % of revenue	0	13	24	14
Individual income tax, % of revenue	0	12	25	12
State gasoline excise tax rates, 1993, cents per gallon	4	19	29	NA

Source: The secondary source is Fisher (1996).

This shows that tax and expenditure policies may differ in an integrated EU. This is not to say that there will be no restrictions on fiscal policy. Taxing according to the ability-to-pay principle will become more difficult. It is likely that instead, there will be more taxes levied in relation to the benefits, which the tax payer has, of the goods and services that the public sector provides.

On the one hand, this is not such a big problem. Most goods that the welfare state provides are not public goods. Public provision of private goods, such as education and health care, is much more important than public provision of public goods. A combination of taxation according to the benefit principle and public provision of private goods can be pursued in an integrated Europe. To the extent that these policies are parts of the welfare state, integration will not be a threat to the welfare state. Countries may differ in their policies if they want to.

On the other hand taxation according to the ability-to-pay principle and redistributive transfers will be much more difficult policies.

To the extent that these policies are parts of the welfare state, integration will affect the possibilities to keep the welfare state.

Sinn proposes two solutions to ease the pressure of international fiscal competition on national fiscal systems. First, he suggests that capital-income taxation should be based on a cash-flow principle that allows immediate write-offs of real investments. Second, he suggests that labor-income taxation should be based on a nationality principle.

Capital-income taxation is a small source of tax revenue in Sweden. Integration will restrict capital-income taxation, but it is difficult to see that this can be an important reason why it would not be possible to keep the Swedish welfare state.

A cash-flow tax also has its drawbacks. The transition may be a problem, there are international complications, and it could create opportunities for tax arbitrage. As Sinn points out, capital-income taxation can be partly rescued if levied on the EU level rather than on the national level. This would be the selection principle at work.

I also think that it is difficult to enforce a nationality principle for labor-income taxation. If such a principle is introduced, there will be room for competition for citizens. If there is competition for ships, why wouldn't there emerge competition for citizens? It could be that we will see considerable increases in the number of Liberians, Bahamians, and citizens of Cayman Islands.

On a European level, I wonder why it would be easier to agree on the nationality principle than on common capital-income taxation.

References

Fisher, R.C. (1996), State and Local Public Finance, Second Edition (Irwin, Chicago).