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Politicians – Slaves Under the Invisible Hand?

A study of the Power of the Economy within the European
Union

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Abstract

This paper examines the impact of the economy on the political. The aim is to show that integration, in particular integration within the European Union has led to economization which has enabled a progression of the power of the economy to an extent where independent political decisions are made impossible. The development is explained through the theoretical framework of neo-functionalism, in an effort to argue the logic and arguments of neo-functionalism as an explanatory force to the development in question. The development is described in general terms, but a specific area of interest from both political and economic perspectives, corporate taxation and the harmonization thereof, is analyzed to a further degree. Harmonization of the corporation tax is not only interesting as it has been intensely debated among the Member States of the European Union; it is also of interest as taxation is a politically contentious area, and as such, a study of the area can hold explanatory power regarding other areas of politics as well.

Keywords: *Economization, Corporate taxation, Harmonization, European Union, Politics.*

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1. Introduction

European integration has taken on a path envisaged by some, unimaginable by others, but unforeseen by most. This integration, which is mainly economic, has had quite substantial effects on both the economic and political worlds as we know them. Whether this development has been envisaged, foreseen, wanted or unwanted is not of importance here, rather how it has come about, and in particular; what the effects have been. The focus of this paper is economization which is noted to be a side-effect of integration. The geographical focus lies on the European Union, but globalization will also be taken into account, as the European Union is viewed as a product of globalization rather than a driving force. It is of uttermost to those in position of shaping the Europe which lies ahead to understand why and how this economization occurs, in order to be able to create that very future.

This paper will argue that today's Europe, and in particular, the European Union, has not been shaped through independent political decision making, no matter how much we would like it to be so. The main standpoint of this paper is that functional demands of economics and of the market imposed through its powers have brought on the European Union that we know today and the Union we will get to know tomorrow. It will be shown through theoretical and empirical examples that it is indeed so.

1.1. Statement of Purpose

The aim of this paper is to show how economization, enabled through integration, has put forth demands on politics, resulting in that the possibilities for states to engage in meaningful economic politics have been diminished, if not erased. The origins of economization are argued to lie within integration; hence, I aim to derive the origin of integration within the European Union. The main focus, however, lies on economization, and how economization has to continuing greater degree gained power and influence over politics. I will argue that economization has created a situation where market powers decide what steps need to be taken in order to move forward. The economy and market pose demands on politics, demands which need to be met, as the alternatives would be highly undesirable, considering both economic and political standpoints. It will be argued that the external pressures on politics within the European Union are strong enough to cripple politicians and their politics, and in a longer perspective, the ability to engage in independent decision making.

My *hypothesis* is that the power of the economy and market powers have seriously harmed the possibilities of independent policymaking within the European Union. Hence, the conclusion that the economy has played a vital part in shaping the European Union and its politics can be drawn.

1.2. Theory

The main argument of this paper is that integration within the economic sector has spurred development within the political sector as well as resulting in economization of the political to the extent where political power becomes inferior to the economic. The cause of economization is intimately related to integration and globalization, as the economy becomes more and more important through these two forces. As integration is the fundament of what I aim to explore further on; economization of the political, I intend to explain processes of integration which can in turn give us better understanding of economization as well. Neo-functionalism has long argued this development, and is therefore an excellent tool in explaining European integration from the chosen angle. In part, this paper is thesis-driving; mainly regarding the influence economics has and has had, but also in regard to neo-functionalist logic. So, not only will neo-functionalism be used as a tool in explaining development within the European Union, the theory and its explanatory powers will also be put under the microscope.

1.3. Method and Material

In order to show that economics has indeed had immense power over the political in the European Union, I will use the theoretical logic of neo-functionalism which proposes such development and explains the whys and hows. Further, I will show how the logic accords with historical evidence of European integration. It is also of uttermost importance to use a current example, one of importance for today, but also regarding the future. For this purpose I intend to use taxes, and in particular corporate taxation, as an empirical example. Taxes are chosen as an example as it is a traditional and contentious political area, and if it can be shown that economic rationale have had longstanding influence on this area of politics, it is likely that this is true relating to other political areas as well. The empirical case study portion of this paper hence takes the form of a least likely case scenario. Sweden will to some extent be used as the geographic point of take off as Sweden is a traditional welfare state, and as such, highly dependent on the possibilities to engage in independent fiscal policy.

This study is interdisciplinary and will therefore consider both economic and political literature, in particular regarding the case study portion of the paper; taxation. The theoretical groundwork will be based on literature written within the field of political science, more specifically, literature on European integration.

1.4. Disposition

The second chapter of this paper brings forth the theoretical framework of the chosen theory; neo-functionalism. It derives the theoretical origins of integration, and thus; in a longer perspective the origin of economization. The following chapter focuses on the economic perspective, and unloads the main focal point; taxes and harmonization thereof. The main aim of the chapter is to describe and explain the economic rationale for tax harmonization within the European Union. The following chapter, the Political Perspective, analyzes the political consequences of economization and in particular, of tax harmonization in order to analyze the

political desirability of a harmonization. Chapter five of this paper consists of an attempt to analyze the economic and political perspective with the theoretical framework. A concluding discussion will follow in chapter six.

2. The Neo-functional One Way Ticket

The European Union has been described as an economic giant, a political dwarf and a military worm. Is this the result of political integration as a follower to economic integration? Has economic integration put forth functional demands on political integration in order to enhance and widen the scope of its territory of influence?

What has been said to be an obsolete theory has shown inadmissible in studying the integration of the European Union, and in particular the effects economic integration has had on the political. All agree today that we cannot think about the analysis of European integration without confronting neo-functionalism (Rosamond 2000 p. 50). The theoretical framework of this paper will be based on the groundwork of neo-functionalism. For this purpose I will give an overview of the theory. In order to bring legitimacy to the argument that neo-functionalism is indeed an integral source whilst contemplating European integration I will scrutinize the theory and bring forth critique which has been directed towards the theory and rebut that very critique. Further on, I aim to find patterns in the history and structure of the European Union which coincide with the theoretical logic. Lastly, I will apply the theory to the main argument of this paper; the economization of politics within the European Union, and in particular, the issue of taxation.

2.1. Neo-functionalism; the Stylized Facts at a Glance

David Mitrany is considered to be the founder of functionalism. Although this chapter will touch upon the principals of functionalism, the neo version of the theory is emphasized to a greater extent. Ernst Haas and Leon Lindberg are the foremost figures of this newer and (in their minds at least) improved version of functionalism.

It is vital to define the concepts which are used within the theory. Integration denotes the bringing together of parts into a whole as well as compromising measures that entail the suppression of some forms of discrimination (Belassa 2003 p. 180). Economic integration is defined as removal of trade barriers, in contrast to international integration / cooperation which refers to international agreements on trade policies. Economic integration will result in various effects which arise from divergences in national monetary, fiscal and other policies, which in turn will have an effect on a political dimension as well. Haas defined political integration as the process through which political actors in several distinct national settings are persuaded to shift their loyalties, expectations, and political activities toward a new center, whose institutions possess or demand jurisdiction over the pre existing national states (Lindberg 2003 p. 154). Further, neo-functionalism considers integration to be a process rather than a static state, and hence emphasizes process rather than outcomes. The process is at large defined by unintended consequences and spill-over effects. This development takes place when states assign responsibility for accomplishing a limited task, and then discover that satisfying that function has external effects upon other of their independent activities

(Schmitter 2004 p. 46). In terms of economics and politics, the main argument of neo-functionalism is that economic-social integration will spill-over into political integration.

2.1.1. The Transformative Cycle of Neo-functionalism

Rosamond (2000 p. 51) outlines the transformation, or development if you will, of regional integration in terms of functionalistic logic. The first step towards integration is what seems to be a quite limited cooperation, limited both in terms of scope and authority. It is however, vital that this cooperation takes place in areas of “low politics” but in key strategic economic sectors. To oversee the cooperation within above mentioned areas, a high authority is assigned, an authority which can act without the interference of national self-interests. The supranational authority’s task is to oversee the integration process and also make possible, as well as act in favor of further integration. The economic integration creates functional pressure for integration in relating sectors, leading to an entangling of national economies. The supranational authority will then be enabled to usurp power at the expense of the nation states and their institutions. Principals of nation states will resist this development. A shift in loyalty will take off, a transfer which takes place in the search for the most effective fulfilment of material interests. As economic integration deepens, a need for further institutionalization is created. In plain(er) English, political integration is an inevitable side-effect of economic integration. While principals will resist this development, the resistance will challenge what has already been accomplished, and national governments will prefer expansion to contraction, enabling the escalating integration.

2.1.2. Spill-over Effects

As mentioned earlier, spill-over effects are central to the integration process in neo-functionalism. Spill-over takes two main forms; the first being the functional form which arises from the interdependency between economic sectors within modern economies (Nugent 1999 p. 507). This interdependency makes it difficult to confine integration to one sector; instead, integration in one specific sector puts forth pressures for further integration within related sectors as well. The second form of spill-over is that of political spill-over. Political spill-over is also an effect of economic integration but is more dynamic and dimensional than the prior example. When economic integration has been initiated, attention is turned to supranational levels of decision making and activities, resulting in the creation of a common goal among those involved, leading to a shift in loyalty towards the supranational (ibid.). Hence, national states and governments become less influential, while the level gains power. As a result, integration becomes of even greater importance giving rise to demands for political control and accountability at the supranational level (ibid.). Lindberg, one of the foremost minds of neo-functionalism, defines spill-over in Rosamond (2000 p. 51):

“... a situation in which a given action, related to a specific goal, creates a situation in which the original goal can be assured only by taking further actions, which in turn create a further condition and a need for more action and so forth.”

In short, neo-functionalistic spill-over refers to an effect, or unintended consequences, unforeseen by the political actors. Political (or economic) decision making within one field or sector can spur a transformative development with unknown consequences. The dynamics of spill-over are highly dependent on the fact that the support for integration is the result of common expectations and objectives. While they are often competing goals they result in new activities and demands, which in turn provide the basis for further convergence and thus also further integration (Lindberg 2003 p. 159). Economic integration of large scope can result in spill-over between sectors. When disparate national interests are involved, conflicts over further integration in a given sector may be solved by bargaining between sectors, resulting in spill-over effects beyond the borders of economic sectors (Lindberg 2003, 160). This cycle will continue to unknown extent, what is inevitable is however that integration within one sector, usually an economic sector, will de facto lead to further integration, including integration within related sectors, but also within the political sphere.

Political spill-over is also influential regarding integration of the institutional arrangement. Problems of agreement between Member States and their governments may result in the expansion of scope and level of authority assigned to the central institutions (Lindberg 2003 p. 160). In order to reach common decisions, governments choose to delegate difficult problems to supranational levels of authority. Integration may also be actively furthered by the institutions and their actions, by creating situations which cannot be dealt with without further development of the central institutions and policies (ibid.).

2.1.3. The Neo-functionalistic Conception of the European Union as Polity

The description of the EU as a problem-solving entity is shared by both intergovernmentalists and neo-functionalists (Schmitter 2003). This conceptualization of the Union is characterized by a view of the EU as a functional organization, and more specifically, as an international organization, created with the aim to address problems which the Member States cannot resolve independently (ibid.).

2.1.4. Critique and Backlash

During the lapse of time there has been considerable critique directed at neo-functionalist theory, even to the extent that the forefathers themselves have retreated from the original model. The critique blossomed during the European crisis during the 1960's and the world economic recession during which integration came to a halt. One major argument against neo-functionalism has been that the theory takes absolutely no consideration of forceful political actors and changes in the external security, but gives too much weight to spill-over and functional demands (Nugent 1999 p. 508). Further, the theory does not include the forces of the interests of the Member States and their representatives (ibid.). Neo-functionalists have been said to be overly concerned with the political results of integration, even if little attention is paid to the political dimension of the integration process (Belassa 2003 p. 179). Even though supranational institutions may have considerable autonomy in running the day-to-day affairs of the Union, decisions about treaty change or substantial institutional reforms are

dominated by national governments. Therefore, it is argued, one needs to take into account the role played by both the Member States and supranational institutions, and their role in the process, rather than what the results are. Neo-functionalism has at least in my mind stood out as a process-oriented theory, which is why the above mentioned critique confuses a bit.

Further, it has been argued that neo-functionalism is to be disregarded as it cannot be applied to any other entity than the European Union. But as the European Union is *sui generis*, there is a need of development of dedicated theories of integration (Butler 2001 p. 423), which cannot be applicable to other entities, because if they were, they wouldn't be applicable to the European Union, as the EU is in a category of its' own.

It has also been said that the theory is far too deterministic in its approach, leaving little space for alternative paths. Haas and Lindberg – the foremost figures of the theory, partly agreed with the critique, and suggested that future integration theory would need to give greater recognition to, among other things, nationalism and the role of political leadership (Schmitter 2003 p. 52).

Perhaps neo-functionalism does leave little to chance, but has still proven to be instrumental in explaining European integration so far and the underlying factors. Outside factors, such as crises and recessions have resulted in an apparent loss of the explanatory force, but the theoretical logic seems to have been remarkably correct in many other situations. The argument also gives rise to the question of which theories of integration were *de facto* correct during times when integration barely took place at all. The question at hand is whether neo-functionalism can facilitate predictions of how integration is likely to proceed. The question, as it is futuristic, is impossible to answer, but since it is applicable to use in hindsight, it gives me confidence to use while looking forward. Jeppe Tranholm-Mikkelsen concluded that while neo-functionalism may be dealing only with “some part of the elephant... it appears that those parts are amongst the ones that make the animal move” (Nugent 1999 p. 508).

3. The Economic Perspective

Harsh economic rules to play by have forced individual states to homogenize. The rules of the game have made independent political choices less and less possible. A bit simplified, yet that is the main argument of many who aim to explain the effects of global integration (Erlingsson 2001 p. 140). Are we faced with the “end of history” as proposed by Fukuyama (1992)? And if so, is that due to neo-liberalist version of capitalism is perceived as the better of choices, or due to it being the only alternative and as such inevitable? The Swedish government of 1991-1994 spoke of “the only possible politics”, which is quite illustrative as well. It was argued that certain actions and measures were *necessary* and *inevitable*. Deregulations followed which gave the market even more power and influence (Erlingsson 2001 p. 140).

Paul Hirst and Graham Thompson paint a picture which is also quite illustrative of the road taken (Hirst & Thompson, 2000 p. 49)

“Social solidarity and collective reinsurance against economic shocks are obsolete; international capital will only accept a minimum of safety net and the barest of intervention consistent with market led efficiency. Social democracy in any meaningful sense is dead. The project of humanizing and civilizing capitalism, so that a market society without losers could be created and sustained, is obsolete when self-interested corporate elites and global markets call the tune”.

The aim of this paper is to show that it is indeed as claimed by the Swedish government, Hirst and Fukuyama. There are no real choices, the demands posed by economization and the market has to be met in order to survive. The scope of the paper is the European Union, and taxes will be used as a case study. Taxes have been chosen as a case of study for this paper as it is a very traditional and politically contentious area of politics. Taxes make up the foundation of the welfare state; which in Sweden is “everyone’s sweetheart”, a sweetheart which most are unwilling to give up. Hence, we would all like to believe that decisions concerning taxes are made solely on the basis of independent political decision making by those we have elected to represent ourselves and our interests. My aim is to show how economics has gained in influence over politics. If it is so concerning a matter of such political weight as taxes, it is highly likely that the same goes for other political areas.

3.1 Politically Contentious Taxation

Taxes are indeed a hot potato within European politics. Tax policy is a highly politically contentious area as it reflects profound differences in social and economic philosophy. As such, many Member States of the European Union wish to maintain the issue of taxation within the borders of national sovereignty. Member States with a large public sectors and societies which fundament on the existence of the welfare state are particularly keen to keep tax policy within the realm of national sovereignty. Sweden is one of these Member States. During the negotiations which lead to the realization of the new European Constitution,

Sweden was particularly concerned over the future possibility of independent tax policy (Wohlin 2005-04-19). At present, Member States do enjoy exclusivity over tax policies; I aim to show, however, that considering the amount of integration which has taken place, it is nearly impossible for taxes to remain solely within the realm of the nation state. Member States will at some point be forced to consider some form of homogenization as the alternative offered is highly undesirable, both politically and economically. That fact does not necessarily directly depend on any constitution, treaty or directive, etcetera, but rather on the economy and the integration of the same which has been enabled through those very treaties, directives and possible future constitution. There is a mismatch between the existence of a single market and twenty-five corporate tax systems; and if profits are made on a European wide scale, why should they be taxed on a national scale? Important to note however, is that additional steps toward tax harmonization don't automatically follow for example the Treaty of Rome or the Single European Act, but, all measures taken must be consistent with the treaties (Kopits 1992 p. 1).

3.1.1 The Corporate Tax Rate

The freedom of movement of capital, persons, goods and labor which lies as a foundation to the internal market, has had its implications on the degree to which Member States can independently make political decisions, including decisions regarding taxes. In particular, the corporate tax rate has been frequently and intensely debated, much due to the fact that capital is one of the more mobile factors of production, in comparison to for example labor which still has a long way to go before reaching the same degree of freedom of movement. The implications regarding the mobility of labor is not due to legislation, legally, the movement of labor is just as free as that of capital on paper, but more difficult to implement due to external factors. Divergent tax rates have been argued to obstruct the free movement of capital and thus also the implementation of the internal market.

3.1.2. Corporate Tax Harmonization Discourse in the EU

The Treaty of Rome implicitly required the harmonization of the corporation tax by Article 94(ex article 100) (Robson 1998 p. 181). The Article states that:

“The Council shall, acting unanimously on a proposal from the Commission and after consulting the European Parliament and the Economic and Social Committee, issue directives for the approximation of such laws, regulations or administrative provisions of the Member States as directly affect the establishment or functioning of the common market”: (Treaty of Rome – establishing the European Community 1957).

The formulation of the Article is quite direct, implying that Member States as well as the institutions of the Community ought to take sufficient measures to ensure implementation of the common market. The Treaty itself, however, provided little specifics on policy formulation in the area of tax harmonization (Robson 1998 p. 181). Proposals of corporate tax harmonization for the (then) EC were formulated in the early 1960s (Regul & Renner 1966 p. 116). A comprehensive proposal was made in 1975, and though some support seemed to exist

for harmonization of tax rates, the same could not be said about the harmonization of tax bases which was regarded as exclusive to the Member States (*ibid.*).

The matter showed up once again on the agenda as it would many times in the future, following the Maastricht treaty which, as mentioned earlier, marked a new era for European integration. Maastricht put the vision of the internal market into print. The taxation issue reflected fundamental difficulties of establishing that true internal market, hence resulting in a discussion concerning the need for harmonization (Urwin 1995 p. 237).

The Single European Act of 1987 outlined the ambitions of further economic integration, which more specifically meant to dismantle the physical, technical and fiscal barriers (the latter including indirect taxation), to free trade, the Treaty of Maastricht took integration a step further with the ambitions to integrate the economy through fiscal convergence and monetary coordination. Inevitably, such convergence and coordination had to mean, that in the long run, taxes would be affected. However, at that early stage, it was impossible to not draw attention to the political consequences as had been in other areas, which put an end to the formal discussion (Urwin 1995 p.237)). Since then, almost 15 years later, the economy and the implementation of the internal market has put its toll on the issue, and politicians have come to terms with the fact that in a longer perspective, some harmonization of taxes within the European Union is indeed needed in order to maintain and secure the continuing integration and implementation of the internal market (Södersten & Ysander 1983 p. 8). The removal of border controls and restrictions to trade is intimately connected to tax harmonization. Lack of sufficient harmonization may inhibit the completion of the single internal market, and would thus be in defiance of the Treaty of Rome (Kopits 1992 p. 1).

In the present, official and dominant discourse the corporate income tax is a question that the Union has to address because the present state of affairs leads to severe distortions which are not in accordance with the common market and the conditions which should be provided to economic actors (Menéndez 2005 p.16). As things stand, efficiency losses are incurred, and the international competitiveness of European companies is harmed and subdued. Not only is there a problem with the efficiency losses of distorted allocation, but there are also problems with double taxation, or when cross border restructuring is penalized by taxes which will not be due on purely internal operations. A structural reform of corporate income taxation is more or less a prerogative to solve the present problems. The Commission argues that there is a need for a European definition of the corporate income tax base applicable to at least the big corporations (*ibid.*). The attempts to harmonize even limited parts of the corporate income tax however, so far, have been fruitless, and have resulted in repeated failures.

3.2. Decreasing Corporate Tax Rates in Europe – Reasons and Effects

Within the European union of today, the decreasing tax rates are obvious, especially concerning the corporate tax rate. During the past six years, the corporate tax rate within OECD countries has decreased by six percent (Andersson & Söderström 2004 p. 50).

Much of this development can indeed be accredited to the economic integration which has taken place within the European Union. According to traditional economic theory, a country's gross domestic product is intimately related to factors such as investments in material capital, human capital and level of technology (Jakobsson 1999 p. 329). Do tax rates in turn affect

these factors, implying that they indirectly affect a country's economic growth? If so, can it be said that there is a general interest among Member States to engage in tax competition in order to maximize their own gains and utility of the system (meaning the European Union with the internal market and so forth)? And has, the system spurred on the incentives to engage in competition, through its internal market? So, put shortly, does the economic integration which has followed through the European Union lead to tax competition which isn't necessarily desirable for all Member States, in particular traditional welfare states? Are the market and the economy thus putting forth demands on politics which cannot be written off or ignored, making politicians slaves under the invisible hand of the market?

3.3. Economic Rationale for Harmonization

Before attempting to bring forth the arguments for tax harmonization, it is integral to define what is meant by tax harmonization. It has been suggested that harmonization refers to

“any situation where differences in taxation between the states (or provinces) are reduced either by co-operation among the states or by a federal government policy”(<http://www.indiainfoline.com/bisc/acct.html>).

Perhaps the main arguments for harmonization of tax systems lie within the scope of securing the implementation of the single market and the free trade therein as well as attempting to reach “an ever closer union”. There are, however, several more factors and arguments to be considered. .

3.3.1. Discrimination, Distortion of Competition and Allocation of Resources

As mentioned, it is indisputable (at least according to economic theory) that economic growth, implying gross domestic product more specifically, is affected and related to factors which in turn are affected by tax rates.

The primary aim of corporate business is to maximize the market value of the company in question. Potential investment objects are hence valued by the profit it generates. Corporate taxes can therefore affect the level of investment either through making the demand for returns larger, or through changing the profit. For small, open economies, which are price takers in capital markets the demand for returns is a given since the countries cannot affect the demand on the world market since the capital will continually seek itself to where it will generate the most profit. This is however, only true for the mentioned small open economies, and important to note is that not necessarily all Member States are price takers in capital markets (Kopits 1992 p. 73). Large countries can through domestic demand and supply conditions affect the rate of return on financial assets and hence also distort the relative cost of funding investment in domestic as well as foreign markets (ibid.). These countries are not, however, in question for this purpose as such, but important to bring forth nevertheless as the actions of these larger countries will de facto affect the smaller economies among the Member States, being price takers and all.

Relatively high taxes on income from capital will, according to economic theory, discourage capital formation, as the primary goal of corporate business is profit maximization. It is quite straightforward that high corporate taxes will result in lower returns on income, which in turn means that the country in question will lose investments which instead will be placed abroad (SOU 1998:1958 p. 186). The free mobility of capital which the Member States of the EU enjoy spurs this phenomenon since it makes the conditions for investment across Member States foreseeable. The corporate tax wedge describes the difference between the before tax rate of return on the real asset and the market rate of return on the underlying financial asset. If the cost of financing increases to cover the market rate of return on the financial asset, the size of the desired capital stock will be reduced. Integration of financial markets does indeed affect the underlying financial asset, but is decided by world markets. But, considering the level of integration within the borders of the European Union, and the removal of barriers to free movement of goods, labor and capital under the Single European Act and Maastricht exposes investment decisions to differences in tax burdens across Member States. So even if it is world markets which decide the level of return on capital, the European Union has created a transparency on the financial markets which has had a substantial effect. The transparency of differences in tax rates will lead to allocative distortions with resulting economic inefficiency, as capital will be placed in the country with the lowest tax rate and not necessarily the best overall conditions. This is why many economists argue that efficiency would rise if the systems were (more) homogenous (Bruzelius 2004 p. 118) In addition; a globalization of production is under way, much due to decreasing transport costs, technological development and substantial deregulations (Eklund 2002 p. 77).

Today, it is not difficult to finance large investments under the condition that the returns on the investments are high as well as an attractive corporate climate. It may be validly argued that an optimal allocation of resources in combination with a reorganization of industry along Community rather than national lines would reduce production costs. A result, the industries of the Community would be enabled to enjoy economies of scale similar to those enjoyed by their American and Japanese counterparts who already enjoy the benefits of a large home market for their productions. Also, the divergent tax rates within the Community is discriminating and in defiance of the Treaties. In illustration of the last point, to obtain the same after tax return, the before tax return that an Irish company must generate is twice as high on an investment in Spain as on one made in Germany (Robson 1998 p. 186). Fiscal disharmony deprives industries of the Community of the advantages enjoyed by counterparts overseas which do not have to face the phenomena resulting from divergences in tax systems, in addition to discriminating Member States. The argument for harmonization here lies within the desire to increase the world market competitiveness of Community industries.

In addition, harmonization would decrease administrative cost factors originating from the different fiscal systems of the various Member States. The costs of tax planning and accounting devices can be relatively high, resulting in an increase in the burden of enterprises seeking expansion in the European Market. It is held that some degree of tax harmonization would reduce the financial costs of establishment and/or expansion.

3.3.2. Foreign Direct Investment and the Effects of Taxes

Leaving the scope of businessmen and turning more to the interests of nation states, I intend to scrutinize foreign direct investment (FDI) and the effect tax rates have on FDI. I intend here to show a different perspective than the latter, but I wish to note that I am not implying that foreign direct investment is not an integral factor within corporate business, quite the contrary. As mentioned, the discussion about tax reform and/or harmonization within the EU rely heavily on the belief that tax rates have important implications for the behaviour of multinational firms and more specifically, where they decide to allocate their resources. Hence, there is quite extensive literature on how foreign direct investment or new plant decisions are affected by company taxes. The Ruding Report (De Mooij & Ederveen 2003, p. 673) concludes that company taxes have a significant negative impact on the inflow of foreign investment. Concerning Europe, De Mooij (2004) suggests that intra-European investment flows tend to be more responsive to tax rate differentials than do intercontinental flows.

Foreign direct investment (FDI) generally refers to investments by multinationals in foreign controlled corporations such as affiliates or subsidiaries. FDI consists of different categories, such as direct net transfers from a parent company to a foreign affiliate, or reinvested earnings by a foreign affiliate. In general though, FDI is associated to the allocation of real capital, which is of main interest here. But, FDI is also comprised of several types of capital, such as real investment in plants and equipment or financial flows associated with mergers and acquisitions (De Mooij & Ederveen 2003 p. 675). Circa 60% of all FDI in developed countries can be accounted by mergers and acquisitions according to OECD (ibid.). Of interest here is FDI in a more general perspective, but that does not make it less important to bring forth the different types and categories which can be implied when speaking of FDI. Of main importance is however how taxes affect the decisions of multinationals to invest abroad. A widely accepted theory regarding FDI is the Dunning approach (ibid.). According to the theory, FDI is attractive to a value maximizing firm if the so called OLI conditions are met. OLI refers to Ownership, Location, and Internalization. A first condition is that it must be an advantage in ownership (abroad) in comparison to ownership by local firms. This can be affected by factors such as technological or organizational knowledge of the multinational, but can also be related to issues concerning taxes. Secondly, there must be some form of comparative location advantage in order for a company to produce abroad. If not, a decision to export rather than invest would be more economically rational. Lastly, it must be attractive to undertake activities within the multinational, rather than outsourcing (buying or leasing the activities from other firms).

Taxes can, according to De Mooij (2004), affect all the different conditions presented in the theory. The tax rate may hence in part determine the attractiveness of a location for undertaking investments. That having been said, it is important to also know to which degree taxes affect FDI. De Mooij and Ederveen (2003), find a median tax rate elasticity of foreign capital of -3.3. An elasticity of -3.3 implies that a one percentage point reduction in the host country tax rate raises FDI in that country by 3.3 percent. The opposite, a 1 percentage point increase in the tax rate decreases FDI by 3.3 percent. The elasticity of capital formation is important in determining the allocative implications of differential tax rates, and conversely, of a potential harmonization (Kopits 1992 p. 87). The responsiveness of FDI to tax rate changes has increased in later years, apparently reflecting the greater mobility of capital (De Mooij 2003). The study was not confined to the European Union and its Member States but

compromised of several countries across the world. It is plausible that the elasticity of foreign capital within the European Union is higher since, as already mentioned, intra EU investment flows tend to be more sensitive to tax rate differentials than for example flows between the EU and the US (intercontinental flows).

Concluding, it can be said regarding FDI that there are several factors to be considered, but that taxes do indeed matter to those in power of allocating the capital which is of such importance for all states.

3.4 Ireland vs. Sweden – an Empirical Example of the Taxation Effect

Among OECD countries, the corporate tax rate has decreased significantly the past few years. Ireland, Estonia and Iceland in particular, have decreased their tax rates substantially. The corporate tax rate in Ireland today is 12.5 percent (PriceWaterHouseCoopers). Ireland has, since the 1970's, climbed far on the ladder of gross domestic product per capita, from a low position in the bottom range among OECD countries to one in the top. In comparison, Sweden has taken a few steps down. So, the immediate question which comes to mind is whether the success of Ireland can be accredited to their decreased tax rates. The Commission for Swedish trade and industry published a report in February of 2005 which concluded that Sweden had lost 101 billion SEK in foreign investment (Swedish Trade and Industry, economic report of 2004). This is the result of the past five years of economic policy, a time during which, in comparison, Ireland has experienced a substantial flow of capital into the country. Is the development of flows in and out of Ireland and Sweden respectively a result of the different tax rates? Ireland's corporate tax rate is indeed low, but in comparison to EU-15 so is Sweden's at 28 percent. However, the corporate tax rate of Ireland is still substantially lower, and it is frequently discussed whether or not this can explain the inflow of capital and thus also the vivid economic growth. It has been shown that Ireland, through it's low corporate tax rate has indeed enticed foreign investment, and the corporate tax rate cannot be overlooked as an important power of attraction concerning capital and investment of the same (Ernst & Young, corporate tax service).

Although most agree that Ireland indeed has profited due to the decreased corporate tax rate, not all see a future tax war as a result of Ireland's actions and following success. Debonis (1997b) argues that one must also consider other factors which may influence the competition, and in particular, factors which encourage states to refrain from engaging in tax competition, such as location specific profits or the possible need for increase of other taxes if the income from corporate tax would diminish. And it is correctly argued, there are other factors to be considered, and Ireland is not a large economy and does therefore not hold the same power of influence as the larger economies of the EU. Or, so it was. With the growth of Ireland's economy which has followed due to their tax policies, so has their influence. Another issue at hand is that Ireland was one of 15 Member States when the tax policy was reformed. Ireland represented the South and the remaining Member States the North in a North-South agreement, where South was in need of a push forward to catch up with North (Debonis 1997b p. 29). Today, the EU has gone through an enlargement with new Member States; several of whom can be said to represent the South; all eager to converge to the

income levels of the rest of the EU. This is indeed a different situation from the time of Ireland's reform, and may spur the competition.

3.5. Tax Harmonization – a Functional Demand?

At this stage we have come as far as being able to say that the corporate tax rate indeed does have an effect on the inflow of capital into the country in question. We have not, however, pinned down the argument that integration will impact to such an extent that independent political decision making is made impossible and obsolete, which was the aim of this paper. The development so far has indicated that tax competition is indeed a reality, on the world market, but in particular within the European Union. In order to avoid a 'race to the bottom', the governments of EU Member States will eventually be forced, willingly or unwillingly to take action. As much as Sweden has shown unwillingness to harmonize, uniform, or coordinate the tax rates, corporate as any other, today's development may lead to a future situation where such a decision will not be taken independently. If the alternative to tax harmonization is tax competition resulting in a race to the bottom, there is really no choice in the matter.

3.5.1. The Undesirable Alternative to Harmonization – Tax Competition

Harmonization of taxes has already been defined as a process which removes fiscal barriers and discrepancies between tax systems. Tax competition, on the other hand is a governmental strategy of attracting foreign direct investment and high value human resources by minimizing the overall taxation level (http://www.en.wikipedia.org/wiki/Tax_competition).

A country's choice of tax rate influences the decisions taken by other governments, especially in highly integrated regions such as the EU (Debonis 1997a p. 29). This fact would, in the search of capital and investments, lead to a tax competition which would eventually hit bottom, thus the phrase 'race to the bottom'. Alternatively, we would end up with positive tax rates and revenues, which would not be optimal either since countries don't internalize the spill over effects of the tax rates (ibid.). When countries set their tax rates completely independently, the equilibria are pareto inferior to the cooperative alternatives since the countries don't take into account the externalities which arise from tax base usurpation and tax burden export (which may affect neighboring countries as well) (Debonis 1997a p. 18).

An alternative to independent fiscal policy and competition is concerted harmonization, one set by, in this case, the Union. Concerted harmonization and with the resulting uniformity eliminates international distortions, inefficient allocation of capital and asymmetry among Member States, but a set tax rate may be inefficient in many regards (Debonis 1997b p. 6). An efficient tax system is inevitably not the same for all countries. The tax system of a country will depend on the public expenditure needs, that is, the size of the public sector (and thus also the mix of private and public sector) and the welfare state. Harmonization will not allow for the respect of differences in countries preferences regarding these issues. In principle, countries could therefore be worse off as a result of harmonization. But, the alternative is competition, and uniformity 'achieved' through competition would also disregard differences

of preference, the difference being that competition would lead to even lower tax rates through the mentioned “race to the bottom” phenomenon. As tax rates are decreased, so will the losses deriving from taxation within each country. However, since taxes may go down too much due to international spill over effects which are not internalized when taxes are set strategically, system competition cannot lead to an optimal outcome either (ibid.). It is also of importance to bring forth the fact that due to different revenue needs of countries, i.e. their different social welfare functions etcetera; it is not simply possible for all countries to engage in tax competition (Kopits 1992 p. 4)

3.6. Summing up

The theoretical rationale for a corporate tax harmonization within the EU is in fundament that it would eliminate the distortions created through independent fiscal policies. Harmonization will to a greater extent ensure efficient resource allocation as decisions to invest at home or abroad would then depend on the before tax rate of return. As with the case of the European Union where restrictions and regulatory barriers to trade have been removed, inter country tax rate differentials play a major role in resource allocation. Hence, harmonization would lead to greater transparency of economic decisions and also diminish inefficiencies. Diminishing inefficiencies would in turn enhance community wide efficiency and welfare (Kopits 1992 p. 2). Also, harmonization would further the implementation of the internal market, resulting in further efficiency gains derived from its completion. Trade liberalization in combination with less restrictive macro economic policies may also benefit non Member States. Obviously, the deeper the economic integration is, the stronger becomes the rationale for tax harmonization. The European Union as a region is indisputably a cooperation of deep economic integration, making the rationale for tax harmonization equally profound and strong.

If it were so that member state governments could chose between harmonization and fiscal sovereignty, I am quite certain that Sweden along with other traditional welfare states would chose the latter option. Preserving Member States’ fiscal sovereignty would enable governments to pursue domestic stabilization, growth, equity and regional development. But, unfortunately, this is not quite the situation at hand. Due to the powers of the market, the choices are tax competition, harmonization, or at the very least coordination of some sort. Tax competition will adapt the tax structure to market conditions, which in the long run will lead to tax rates low to the extent that the social welfare function of the state becomes impossible to finance (Kopits 1992 p. 4). Indeed, governments acting independently do not take into account the effects their decisions have on neighboring countries (ibid.).

On the brighter side of things, for those who maintain that decisions on the levels of tax must remain within the exclusive competence of the Member States, tax competition would contain government spending and thus also further the efficiency of the public sector. This is a public choice perspective, a theory which supports tax competition as a way to discipline governments that otherwise would spend too much (de Mooij 2004 p. 180). Frits Bolkestein, European Commissioner, argues that tax competition which decreases the corporate tax rates in the EU is the correct recipe to spur economic growth (ibid.). However, if taxes become to low, there is no government spending to even contain or discipline. Not all share this negative view on tax competition. The new Member States of the EU consider tax competition an integral instrument in converging to the income level in the rest of Europe. The story of

Ireland has most certainly added on to these ambitions. The low tax rates on corporate profits in some of the new Member States have led to accusations of unfair tax competition and fiscal dumping. Future new Member States may intensify the corporate tax competition in the EU. Most of today's new Member States have quite low corporate tax rates (de Mooij 2004 p. 181). Among the new Member States the average effective corporate tax rate is fifteen percentage points below the average of the EU-15. The enlargement has thus added on to the belief that something must be done to counteract the incentive or economic activity to move from high tax to low tax countries.

If tax competition is harmful, harmonization too great a step towards supranationality, is coordination a possible answer? Kopits (1992) argues that coordination is too weak a measure regarding the European Union considering the depth of the economic integration, and in particular the absence of border controls. A minimum tax rate, however, can, argues de Mooij (2004), combine the better of two worlds. A floor on the corporate tax rate will allow for competition and the benefits thereof, but the competition will be confined to a certain level and hence avoid a harmful race to the bottom. At the same time, given that the floor is not too high, it will not remove the disciplining impact of corporate tax rates, as proposed by public choice theorists. At a first glance, a minimum corporate tax rates seems as the optimal balance between the pros and cons of tax competition and independent fiscal policy.

If the minimum corporate tax rate as proposed by de Mooij indeed is the best solution to the problems posing the European Union today is really not the issue at hand, rather if the implementation of such a measure will be forced upon the governments of Member States as a result of economic integration and forces of the market. Indeed, it has been shown that tax competition within the European Union is a fact. The results of tax competition have also been brought forth, most of which are not pareto efficient. Regardless of its result and the efficiency of those results, tax competition is under way. In this given situation we cannot really afford to discuss the want or need to maintain decisions concerning tax rates within the realm of the nation state, politicians will eventually be forced to move towards harmonization of some sort as the alternative leaves too much at stake. It is obvious that development is moving ahead quickly. In 2002, the Swedish report on tax bases (SOU 2002:47), came to the conclusion that Sweden was not under international pressure to decrease taxes, as many other countries actually would need to increase their taxes to maintain public welfare due to demographic reasons. Further, they argued that Sweden definitely should not engage in tax competition, especially not in regard to the corporate tax rate, which already is low in relation to the rest of EU-15. However, at the same time it was confirmed that as a small, open economy in a highly integrated economic region it is impossible for Sweden to diverge substantially from the other states and their tax rates. It was therefore said that if 'important' countries took a lead, Sweden ought to follow and decrease the corporate tax rate to 25%. Regarding harmonization, it was quite clear that the authors desired further harmonization of the tax systems within Europe, to protect the member state's possibilities to maintain differential tax rates, and avoid tax competition based on low taxes imposed by other Member States.

The decision to harmonize the corporate tax rate may have to be taken regardless of the Member States view on supranational control or interference in these matters, as the alternative; tax competition, would usurp even more of government fiscal power. Further, during times when economic rationale are valued higher than the political, and in a situation where a single EU corporation tax would be ideal in terms of economic efficiency (Robson

1998 p. 187), the issue will not be let to choice, regardless of the political unacceptability of the issue. The market has thus imposed its power over politics, and the economy has won yet another battle.

4. The Political Perspective

So far, only the economic perspective has been argued, very little has been said about the political aspects of a tax harmonization. In order to show that political changes are more or less forced upon us due to economic pressures, we must establish that these changes indeed are politically unwanted, if not, the changes are not forced, but welcomed.

Perhaps the most important argument against harmonized fiscal policy is that as citizens of a democratic state, we must have the fundamental right to decide the size of our public sector ourselves. Broad tax bases must exist at the hands of citizens of the state in question in order to fulfil their wants and needs. In a perfect world, a perfect democracy, perhaps it would be so, depending on your definition of perfect. This chapter brings forth the political and democratic perspective of taxation and harmonization thereof. The argumentation will be grounded on the belief that the existence of the welfare state is desirable. This distinction is important to make as many argue that the threats to the welfare state posed by liberalist structures don't pose a problem, rather that it frees the people of the increment on freedom which redistributive politics have caused (Erlingsson 2001 p. 149). Sweden is a traditional welfare state and as such and Sweden being our main focus point, it is vital to take on this perspective.

4.1. The Power to Tax

“The economic basis for the creation and preservation of democracy is the redistribution of wealth and income among the majority of the people in such a fashion that no elite can permanently dominate the community” (Ratner 1967 p. 22).

The power to tax is intimately related to the power to create and consolidate political communities. The power to tax enables solid civic ties between the members of a political community. Further, the power of taxation fundamentals the financial provision of public goods and services to all citizens, and is the instrument used to redistribute the economic resources of a society. As such, taxation lies as a base to community and liberty to the citizens of that community. The public services created and offered by the public sector guarantee a certain degree of equality and thus also stability. Citizens who continually are deprived of fair access to essential services and insurances against sickness, old age, unemployment and bad luck, will eventually conclude that the political order favors the elite to the detriment of the many. The tax system is a highly political entity, as a redistributive function and by establishing legal and administrative procedures to ensure the redistribution.

4.2 General Democratic Tax Theory

In short, there are three main conceptions of the distributive tax justice: the republican (which equates taxes with sacrifices to co-citizens who are worse off), the liberist or libertarian (which equates taxes with the prices of public goods), and the liberal or social democratic one, which implies that taxes are best conceptualized as a combination of public insurance premiums and the prices of public goods (Menéndez 2005 p. 10). All agree that taxes are an instrument to divide the costs of public goods and services. But why are taxes at all necessary? Why can't the costs of public goods and services be met with the help of the market price system? Well, to a certain degree, perhaps public service could be offered and financed through the market system, but the features which define pure or even quasi pure public goods render it impossible to allocate their costs through market prices. A public good is one which is nonrival in consumption, implying that the fact that one person consumes it does not exclude others from doing the same (Rosen 2002 p.45). In using public goods, individuals may have an incentive to hide their preferences. Even if the good is beneficial to the individual, the services of the good will be offered regardless of whether the individual pays for them or not. The problem of 'free riders' therefore arises. Market mechanisms may fail to force people to reveal their preferences for public goods (and the true willingness to pay), and could thus lead to insufficient resources devoted to finance them (ibid.). A public financing of public goods is therefore to prefer.

The different views on taxes may diverge, but seem to agree that taxes are a necessary element in the redistribution of resources among citizens. Further, it is clear that taxes are intimately related to representation. Representation without taxation is deemed impossible, and taxation without representation would remove the aspect of citizenry, making it democratically undesirable.

4.3 Democratic Implications of Economization

We have so far concluded that power of taxation is equal to community and its legitimacy, taxation stabilizes and ensures equality among the citizens of the community. We have also reached the conclusion that taxes are a necessary element in a democratic society as public goods and services cannot to a satisfying degree be financed through the market. But why must the nation state be the entity? It has been argued earlier in the paper that citizens of a community must enjoy the basic right to decide their own level of welfare and thus also taxes. To this day, the community is still made up of the nation state, although citizens of Member States of the European Union are also, to some extent members of that community. Europeanization of the national tax systems, would however, lead to changes for all Member States, as very few are similar in respect to the national tax systems. A homogenized European tax system would not leave room for regional policy and could, in the case of asymmetric shocks, potentially harm Member States and their finances. It would be impossible for Member States to uphold different levels and sizes of public sectors and spending, and thus also different levels of welfare endowed by the state. The EU-15 all have a tradition of high tax burdens, due to a political culture characterized by the state-rules citizen view of the polity, relatively weak market regimes and economic egalitarianism focused on equality of result rather than opportunity (Mendoza 1996 p. 7). Yet, the systems of EU-15

differ quite substantially, and there is no disagreement regarding the effects of the Eastern enlargement which indeed will exacerbate tensions.

The EU is considered to be the most advanced region in the world in regard economic and financial integration. This has however, argues Habermas, led to that national, independent attempts of protectionism or to return to Keynesian demand stimulating politics are immediately sanctioned by the market and is no longer an alternative for the welfare states of today (Strömvik 2001 p. 72). In addition, the power of the market has resulted in states becoming increasingly dependent on the will of those who hold the power to allocate capital. Hence, governments have been forced to pay their dues to those who already are socio-economically wealthy.

The diminishing possibilities for national states to independently decide their level of welfare has led to further democratic problems. Vertovec argues that the restructuring of society that has resulted from economization has led to increasing income gaps, high unemployment, escalating poverty and attacks on union organizations and fundamental rights (Erlingsson 2001 p.142). In short, economization has meant that the compromise between capitalism and a protective net against the most extreme effects of capitalism; that is, the welfare state; is no longer possible. If economization has had these effects, the question of what a political decision to further the effects will emanate in arises quite quickly. The chapter on the economic perspective which forewent this chapter showed that competition which would lead to homogenization would in turn result the furthering of the economization.

It is therefore true that a tax harmonization within the European Union can be argued for using political reasons. Where as the economic rationale for harmonization are closely related to market-making arguments (completion of the common market), the political reasons reveal the relationship between corporate taxation and distributive justice (as tax dumping leads to social dumping). Again, this is the dichotomy at hand; whilst we wish to maintain the nation state's sovereignty over the taxation power, we will be forced into a situation where it is impossible to maintain it, as the Union needs to take collective action (hence the Member States will need to grant the Union power; resulting in a sovereignty loss for the national governments), in order to avoid the alternative scenario; tax competition which will lead to social dumping.

5. Integration of the Economy; a Neo-functional Straightjacket on Politics?

Is the neo-functionalist logic plausible; are the tendencies throughout the history of the EU as well as today, and in particular; using the chosen example; the corporate tax rate? The theoretical chapter laid out the theoretical framework of neo-functionalism; this chapter aims to apply the theory to the empiricism of yesterday, today and tomorrow.

5.1. Neo-functionalism Applied on the Integration of the European Union

One of the basic assumptions of neo-functionalism is that integration takes place through a transformative cycle, implying that actors as well as the games they play will change significantly over time (Schmitter 2004 p. 66). There is no precedent case to this transformative cycle of neo-functionalism, national states have evolved through war, revolution, dynastic marriage, anti-colonial struggle and so forth, a developing process highly unlike that of the European Union. This fact makes the European Union the only plausible candidate for a neo-functionalist analysis. This fact has spurred the opponents of neo-functionalism, who mean that since the theoretical groundwork is not applicable to any other entity, it must make the theory incomplete. However, the European Union is the most complex polity created and is going to become even more so. The fact that the European Union and its' development is second to none, does not in any way falsify the theory in my mind. Neo-functionalism can assist us in trying to understand why the integration which has added to its' complexity has taken place, and perhaps also what the future will bring.

5.1.1. Yesterday; Coal and Steel – “un pointe decisif”

Returning to the picture of transformation which Rosamond painted, one can see clear tendencies of this development in the process of European integration. European integration did start with a political objective; that of preserving peace in west Europe, but in order to fulfil this goal, cooperation within a key economic sector was needed. The European Coal and Steel Community (ECSC) saw the light of day in 1951. Coal and steel are indispensable resources in warfare, and by locking these resources through cooperation peace was as guaranteed as could be. Haas used the ECSC to show how integration within one sector, for example coal and steel, will inevitably lead to the integration of other economic and political activities.

Schumann's following words show quite explicitly the importance of integration within one very specific sector:

“ L'Europe ne se fera pas d'un coup, ni dans une construction d'ensemble :elle se fera par des réalisations concrètes, créant d'abord une solidarité de fait. ... Le gouvernement français propose de porter immédiatement l'action sur un point limité mais décisif” (Forsyth 2003 p. 199).

(Europe will not be made all at once, or according to a single plan. It will be built through concrete achievements, which first create a de facto solidarity... The French government proposes that action be taken immediately on one limited but decisive point.).

The ECSC meant that a step towards a community of European states had been taken, and the realization of the same was not far away. The Treaty of Rome was signed in 1957, which sealed the cooperation within Western Europe and laid out the foundations for the European Community. The Treaty of Rome was the result of compromise, a convergence of national objectives. Neo-functionalism stresses the fact that integration cannot take place if there is a lack of incentive among Member States, and integration under such circumstances will definitely not be successful. The economic as well as the political scope of the European Community was greater than that of ECSC, although the main objective was to create an economic community. The most central aspects of the community were the four freedoms within the internal market and the creation of a customs union. Participation in a customs union is likely to spur reactions from non-Member States, which in turn may create situations and following problems which can only be resolved through further integration or by expanding the role of the central institutions (Lindberg 2003 p. 160). In order to fulfil the goals of the union, supranational authorities were assigned. The initial task and grant of power to the institutions creates a situation or series of situations that can be dealt with only by further expanding the task and the grant of power (Lindberg 2003 p.159). The duties to be fulfilled by the supranational institutions grew in number, but also in scope, as time progressed, all in accordance with the theory of spill-over effects. The legitimacy and power of the institutions was to some extent taken from the national states, thus undermining the sovereignty of the national states. The integration put forth functional demands on further integration; regarding the common market in particular, adding on to the vigor of the development. The first steps toward the internal market were taken through the Single European Act of 1987. The original steps were chiselled out by the Maastricht Treaty; which called for even further action. The original requirements for the completion of the internal market have since the beginning steadily expanded to include the social dimension, the single currency and to some degree, fiscal harmonization. The transformation led to a debate which has yet to be finished regarding what ought to be valued more; economic rationality or political sovereignty.

5.1.2. Today and the Issue of Taxation

In order to complete an analysis of the extent to which neo-functionalist logic can be said to confer to the European Union of today, it is of importance to bring forth the ideal type of the EU as a polity; as it is by the theoretical framework (neo-functionalism). This characterization

has clear and direct consequences regarding which tax powers would be justifiable to transfer to the supranational level. Specifically, it would entail only those required by the general problem solving tasks of the Union, as well as those required to solve specific tax problems accruing in the relations between Member States. The depth and scope of the Unions powers to tax would then be related to the power needed to create a common market, followed by a single market between the members of the Union. The welfare gains derived from the integration of markets of goods in combination with the necessary abolishment of restrictions (i.e. import tax and of domestic taxes which discriminate against imported goods), implies a close connection between the *functional* objectives of creating a common market and the transfer of certain tax powers to the supranational level. Once Member States agree upon handling common problems jointly, further transfer of tax powers can be expected, especially in regard to the completion of the *single* market. Over time, the establishment and perfecting of a single market may create conditions under which the effective power to tax of Member States might be factually eroded. In turn, we are faced with yet another problem; which can only be solved by means of establishing framework rules, which requires additional transfer of power to the supranational institutions. Clearly, these are tendencies of spill-over into closely related economic areas; forming a neo-functional trap with no way out except that of further integration. The harmonization of the corporate tax rate, or the mutual recognition of national tax systems or some form or another of European corporate tax might be justified with a view to render perfect the common market, but they are much more than just ordinary spill-overs. They are spill-overs which reveal the open political character of the whole process of market-making, since the very beginning of the Union.

It may be that public discourses on European tax powers and norms are constructed on the basis of a conception of the Union as a problem solving organization. However; that may be somewhat misleading. As far as the Treaties go it is clear that new tax powers accrued to the Union must be justified by the idea of implementation of the single market. Today however, the problems faced by the Union require measures and solutions which clearly transcend the conception of the Union as problem-solving, implying that we might be moving towards the point where the spill-overs become political. The present discourse concerning European corporate taxation is a good illustration of this phenomenon. Not only have the demands been put forth to the institutions of the EU, but also towards Member States, as, in this particular case, the Member States' sovereignty is still unchallenged by the legal framework. Which is why the demands must be faced and handled by the Member States first.

5.1.3. The Potential Tomorrow – Political Serfdom Under the Invisible Hand?

The rather short overview of the EU presented in the paper shows the tendencies of spill-over and functional demands which have in part added on to the vigor of European integration. The Member States of the European Union have continually lost power to the Union and its institutions; thus also losing sovereignty. One can also see quite clearly how one action with certain objectives has brought on new actions. These effects are quite obvious regarding the customs union, which more or less demanded similar markets and systems of production within the Member States in order to work efficiently. In order to reach these conditions, demands for cooperation with in other economic sectors, and in the political sphere was

needed. The realization of the four freedoms also demanded further cooperation and political integration, in order to fulfil the objectives of the Treaty of Rome. One obvious example is the free movement of workers which can generate effects such as social dumping if the political room is not harmonized within the union. This calls for political convergence and common decision making on how to avoid the difficulties which may arise. The free movement of workers and the possible social effects it may have has recently resulted in negotiations and discussions among the heads of governments of the Member States. Another example which is of greater importance for the aim of this paper is the free movement of capital. That freedom has enabled capital to move across borders and countries without restrictions and regulations; which has resulted in economic demands on the political for harmonization in order to protect some of the functions and abilities of member state governments, something that will be analyzed to greater extent further on.

Applying dynamics to the picture and using a further reaching perspective, the realization of the common market with its' four freedoms spurred the development towards a monetary union, and the question of what direction that step will take us arises. Not only dynamics have added on to the development, but institutions, such as the European Court of Justice, have shown the import role of institutions and their actions in influencing integration and adding on to its' vigor. The ECJ has shown that actors and institutions indeed are of importance in the study of integration, and that in combination with spill-over effects it can bring integration to new heights.

I don't believe that many will disagree with the above mentioned regarding European integration; the question at hand is really whether or not one can blame or credit the results of integration to that which neo-functionalism argues to be the underlying forces. Are politicians making decisions about the future really unaware of the effects the decision in question will have in a longer perspective? Were the effects of implementing the internal market unknown to those in charge? It doesn't take a rocket scientist to understand that political decisions may have effects reaching further than the intended scope of the decision in question. Another theoretical perspective on the matter, one which can be said to balance neo-functionalism, intergovernmentalism, rests on the firm belief that governments independently (and rationally) choose integration (Strömvik 2001 p. 68). Every time the process of integration has moved forward it has done due to the Member States governments and their interests (ibid.). One question comes to mind though; do the interests change along with integration? As mentioned earlier, neo-functionalism points out that actors as well as the games they play change over time, so in principle so could their interests. The questions are impossible to answer, a fact which is, I suppose, the charm as well as the foundations of theory. But in order to determine in our own minds it is of great importance to decide whether or not the questions posed by the theory are plausible. If we buy the neo-functionalist argument and thus consider spill-over effects and functional demands to be driving forces of integration, it is impossible to make accurate predictions about what the future might bring, as the effects and consequences are unintended. One thing can be said for sure though, if integration continues as it has so far, we will indeed experience "an ever closer union", with all that it entails.

In order to more specifically exemplify functional spill-over (that is, spill-over from one economic sector to another), and in the long run, political spill-over, I intend to touch upon the principles of the European Monetary Union (EMU). EMU is one of the factors which have had great influence on the need for tax harmonization, why it is particularly interesting for this purpose.

The aim to remove barriers to the movement of goods, services, and capital between the Member States has, as mentioned earlier, put forth pressures to further integration. As tariff and non-tariff barriers were removed, the impact fluctuating exchange rates had on intra-EU trade became more and more significant (Blanchard 2000, pp. 391f). Flexible exchange rates result in uncertainty regarding costs of foreign supplies, the price of exported goods and the return on foreign direct investment (FDI) (ibid.). Hence also creating a disincentive to trade and FDI within the European Union which was hardly what was anticipated or wanted. The European Monetary System (EMS) was an agreement between the Member States and their central banks that their currencies would only fluctuate within certain frames. In the long run, however, the EMS was not enough to alleviate the problems, especially with the liberalization of free movement of capital. The next step was to form a plan for a single currency and a monetary union. The EMU was realized through the Maastricht Treaty. Today, the Euro has replaced the national currencies of almost all the EU-15 Member States. The first step towards monetary integration showed functional spill-over, while the following was highly political. The EMU meant much more than economic efficiency, in the long run the EMU also incurs large political costs, as the monetary policy is transferred to the European Central Bank (ECB). National banks of Member States thus lose a substantial portion of their instruments used for economic management and must also agree to run their economies in ways which are compliant with the requirements set by the EU. As deceiving as it may seem, the EMU is much more than an economic term. Of interest is also to look ahead. If Member States are compelled to keep their economies in control by standards set by the union, what are the possibilities of national economic tax and social policies?

6. The End of History?

The very essence of democracy rests on choice by the demos of a society. That choice is extended to representatives who then are to use the power of politics to establish and consolidate a society according to the wishes of the people they represent. There are certain instruments which are essential in order to be able to fulfil the essences of democracy and choice by the people. The possibilities to engage in (macro)-economic politics rely heavily on the power to tax, a fact which is quite straightforward and hardly argued. Further, the power to tax does not only consist of the power to *collect* taxes, but the power to independently decide rates and bases. This is in order to in a longer perspective enable inconsistencies in the mix of public and private sectors among countries and thus also mismatched systems of welfare. This paper has shown that choice by demos concerning taxation is made impossible through integration and economization. This due to the powers of the market economy which are enabled through the fundamentals of neo-functionalism arguing, such as spill-overs and functional demands. As taxation was used as a 'least likely case' scenario, I believe we can justifiably come to the conclusion that the same goes regarding other political areas.

It seems the essence of democracy is crumbling, at least regarding the aspect of economic politics. The integration which has followed through the European Union, which is considered to be the world's most economically and financially integrated area, has led to a transfer of power from politicians to markets. That transfer, if it hasn't already, will make Keynesian politics a thing of the past. Any attempts to engage in such politics are immediately sanctioned by the market. The demands put forth by the market are strong enough to the extent where politics and its representatives have become puppets on a string – a string controlled by the market. There simply is no choice left. Moving forward (with integration, harmonization or the current matter at hand) is the only alternative to moving backward, where moving backward is considered highly undesirable, to any given less desirable than moving forward.

Not only is the idea of politics and democracy at risk, the development has dire effects on societies and politics onward. The question of what *sort* of politics is possible under these conditions arises. If national economies can no longer exist, and if intra national politics give up allocation of resources among its citizens and focus on growth, can national communities, the basis for the welfare state, exist? Several democratic problems have and will arise due to these effects. Increasing income gaps, high unemployment and escalating poverty to name a few. The question of whether there will be any support for this sort of politics also arises, as it entails a loss of social legitimacy, as the many will be marginalized in favor of the few.

Whether we are headed toward "the end of History" where liberalist democracy rules unchallenged is impossible to answer with certainty, we can, however, see that there are tendencies which are leading us in the direction. Regarding the impact the Union has had, and the discourse concerning what can be done to alleviate the situation, I believe we ought to be more aware of the automatic effects of the market and its forces, especially in regard to the

power it has over the possibilities to engage in independent policy making than the encroachment of Brussels per se.

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