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How Not to Save the Euro

Harmonizing taxes and labor laws would hurt both workers in the east and taxpayers in the west.

By MARIAN TUPY

During their meeting in Freiburg last Friday, French President Nicolas Sarkozy and German Chancellor Angela Merkel reaffirmed their "total determination" to defend the common European currency. Supposedly to that end, they've jointly proposed to harmonize taxes and labor regulations throughout the euro zone. That would certainly show strong determination. But it would also risk doing far more damage to the euro zone, and to the entire European Union, than good.

In 2003, Czech President Vaclav Klaus wrote that "European monetary unification is the Trojan horse for overall harmonization of economic rules, policies and laws in [the] EU. I am convinced that any euro-zone problem will be in the future interpreted as a consequence of the lack of harmonization. . . and will lead to another wave of a creeping harmonization."

It turns out Mr. Klaus was correct. Following her crisis meeting with Mr. Sarkozy, Mrs. Merkel told the press that coordinating tax policies and labor laws across the euro's 16 member countries is "not just about currency issues but also about political cooperation, which has to be deepened."

In fact, harmonizing taxes and labor regulations would be a catastrophe for the ex-communist eastern countries in the EU, and would further undermine the public finances of rich western countries such as Germany.

Mrs. Merkel, who grew up in East Germany, should be acutely aware of those points. When East and West Germany reunified in 1990, one of their first moves was to overhaul East Germany's labor regulations so that they matched those of the West. This precipitate harmonization proved disastrous for the much less productive East German economy, which had had no time to adjust to the exigencies of the free market. A decade after German unification and €1 trillion in financial transfers later, unemployment in the eastern part of Germany was more than twice as high as in the west. The staggering size of the financial transfers from the west to the east proved deeply unpopular, and is still deeply resented by the west German voter.


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Politics would ensure that this economically damaging German scenario would repeat itself on a continental scale if attempted today. First, it is inconceivable that workers in western Europe would agree to a significant reduction of their social privileges and adopt the labor standards prevalent in central and eastern Europe. Second, politicians in the EU's ex-communist countries would try to derive short-term political advantages by promising their electorates western European labor standards—regardless of the long-term damage to their economic growth. Labor regulations in the EU would thus almost certainly be harmonized "upwards" and not "downwards." Considering that productivity in the EU's eastern countries still lags behind that in western Europe, unemployment in the former would skyrocket.

Harmonizing taxes would have similarly deleterious consequences. Countries with higher corporate tax rates, such as Germany and France, have long objected to "unfair" competition in countries with lower corporate tax rates—notably in the ex-communist east and in Ireland. With the euro zone's debt crisis, Paris and Berlin now see their opportunity to impose higher taxes on the rest of the EU, supposedly to help achieve the greater political and budgetary coordination they say will prevent the next crisis. Never mind that higher supply-side taxes never helped any economy to grow its way out of debt; what Mr. Sarkozy and Mrs. Merkel seem to forget is that their eastern partners need lower corporate tax rates to compensate for their workforces' lower productivity.

Yanking Polish and Slovakian tax rates up to western European levels would almost certainly reduce investment in central and eastern Europe, and result in a fresh economic downturn in that region. That would, in turn, prompt financial transfers from western Europe, and particularly from Germany.

Its hard to see who would lose more if Mr. Sarkozy and Mrs. Merkel get their way—neither workers in the east nor taxpayers in the west would benefit from such a move. The resulting economic hardship and political recrimination could fatally undermine the entire European project. Now how is that any way to save the euro?

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