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CONTRA: TAXING HUMAN CAPITAL AT SOURCE IS INEFFICIENT AND HARMFUL!

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The European Union is not only challenged by eastern enlargement and the entailed freedom to move of one hundred million additional people. There is a second less recognized challenge that is rooted in the Treaty of Maastricht and the institution of European citizenship. According to the Treaty, every citizen of the Union has the right to reside wherever (s)he wishes to. This ruling contrasts with the legal practice which ties the freedom to move to employment. In particular, welfare recipients lose their claim to support if they choose to migrate. This hardly complies with the notion of European citizenship and it might not be wise to leave it to the courts to close the gap between European visions and common practice.

Welfare payments are part of distributive policy. Economists agree that distributive policy ought not be pursued at the European level. If it is pursued instead at the national level, it is necessary to assign mobile individuals to the Member States. This does not seem to be sufficiently acknowledged by politics. It does not suffice to ban nationality as a means of discrimination and to replace it by European citizenship. If Member States are to be autonomous in redistributing income, there has to be a clear rule on how to assign individuals to these jurisdictions. Hence the question is not whether to make assignments or not but only how to make them.

It is common practice to assign mobile labour according to the employment principle. The OECD

Model Tax Convention is based on the employment principle as is the co-ordination of social security among EU Member States. Taxing labour in the country of employment amounts to taxing human capital at source. The disadvantages of taxing mobile factors at source are well documented in the literature. The practice induces production inefficiency. Moreover, it effectively harms immobile factors of production, because source taxes on mobile factors are shifted backward. In fact, perfectly mobile factors can be taxed on a benefit basis only. But above all, the employment principle is inherently discriminatory since it is not applicable to the non-employed.

The origin principle has been proposed as an alternative rule. It requires taxing individuals in their home country. In contrast to the employment principle, the origin principle sustains production efficiency and safeguards the welfare state. Decisions to migrate are not distorted by taxes and social security. The freedom to move between jurisdictions cannot be misused for selecting among competing distributive systems.

However, the underlying view of redistribution can be criticised for relying on coercion. The implicit assumption is that people have to be forced if they are to bear a fair share of the cost of distributive policy. There is a competing view stressing that distributive policy needs to be approved by the population. Such approval requires a feeling of solidarity between the winners and losers of redistribution. Solidarity cannot be forced on people, however. It has to grow, and it grows best in neighbourhoods and fellowships. The origin principle ignores this as it is oriented towards the past. The employment principle is more integrative. It is responsive to changes in neighbourhoods.

The origin principle has also been criticised for the weak incentives it gives jurisdictions to respond to citizens' preferences. Once individuals have been assigned to a particular jurisdiction, they cannot threaten to exit. That makes them exploitable. The

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origin principle imposes little discipline on Leviathan governments. The employment principle, on the other hand, is more supportive of efficiency enhancing competition among jurisdictions. If neither the origin nor the employment principle are fully convincing rules of assignment, a mix of the two might promise better results. And in fact, one particular mix was recently suggested by Advisory Council to the German Ministry of Finance as a rule for assigning EU citizens. The idea is to leave migrants – employed and non-employed individuals alike – assigned to their country of origin for a co-ordinated transition period and to reassign them to the country of immigration thereafter. The Council calls this assignment rule "delayed integration". The rule is integrative in so far as migrants are eventually assigned to the country to which they move. Jurisdictional integration, however, is delayed as reassignment becomes effective only after a period of transition, say, five years.

The special appeal of delayed integration lies in the fact that it is applicable to the employed as well as to welfare recipients and that it allows to balance the legitimate interests of both the jurisdiction of immigration and the jurisdiction of emigration. One obvious problem with delayed integration is, of course, that it requires delegated administration during the period of transition. But that should be manageable if it is handled on a mutual basis and if the period of transition is not excessive.

In summary, delayed integration is an appealing rule of assignment that the European Union should seriously consider as an optional basis for co-ordinating the autonomous policies of its Member States in the areas of social security and taxation.