Executive Summary
Backgrounder

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Fiscal Policy Lessons from Europe

Daniel J. Mitchell, Ph.D.

The federal government spends an enormous amount of money. Measured as a share of national economic output, budgetary outlays are near a peacetime high, consuming almost 21 percent of gross domestic product (GDP). Whether it is measured in nominal dollars, in inflation-adjusted (real) dollars, or on a per household basis, federal spending in America is at record levels.

Moreover, this is just the calm before the storm. Left on autopilot, the burden of federal spending will increase dramatically because of both demographic forces and reckless policy choices, such as the creation of a new prescription drug entitlement. In a worst-case scenario, the Congressional Budget Office (CBO) estimates that government outlays could consume as much as 55.8 percent of GDP by 2050. Even a more optimistic scenario shows that the burden of federal spending will still nearly double, climbing to more than 37 percent of GDP.

Cautionary Lessons from Europe

Many European nations have already allowed the burden of government to climb to these levels. Government spending consumes more than 50 percent of GDP in France and Sweden and more than 45 percent in Germany and Italy. These nations provide useful lessons about the economic consequences of bigger government, and these lessons suggest strongly that America is on the wrong track. Even a cursory review of European economic performance shows that excessive government has serious adverse effects: slower growth, higher unemployment, lower living standards, and a bleak future. For instance:

- Per capita economic output in the U.S. in 2003 was $39,700, almost 40 percent higher than the $28,700 average for EU-15 nations.
- Over the past 10 years, the U.S. economy has grown at an average annual rate of 3.3 percent in real terms, 50 percent faster than the EU-15's growth rate of 2.2 percent.
- A comparative study by Timbro, a Swedish think tank, found that European Union countries would rank with the very poorest American states in terms of living standards, roughly equal to Arkansas and Montana and only slightly ahead of West Virginia and Mississippi, the two poorest states.
- In August 2006, unemployment in the European Union was 8.0 percent, including a 7.9 percent unemployment rate in the group of nations that use the euro. The U.S. unemployment rate in the same month was only 4.7 percent.

This paper, in its entirety, can be found at:
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- A study by Eurochambres estimated how long it would take Europe to catch up to America, assuming no more growth in the U.S. It would take Europe 18 years to reach U.S. income levels, 14 years to reach U.S. levels of productivity per employee, 24 years to reach U.S. levels of research and development investment, and 26 years to reach U.S. employment levels.
- In 1980, foreign direct investment in the United States totaled $127 billion, according to the Bureau of Economic Analysis. Today, it totals more than $1.7 trillion. In 1980, there was $90 billion of foreign portfolio investment (just counting holdings of government and private securities) in the United States. Today, there is more than $4.6 trillion. Much of that money—capital that finances new investment—comes from Europe and at least partly reflects the more market-oriented policy environment in the United States.
- Americans enjoy more leisure than Europeans because they can afford to purchase labor and goods that reduce the amount of time spent working at home. According to one German study, "overall working time is very similar on both sides of the Atlantic. Americans spend more time on market work but Germans invest more in household production." The report further notes that "these differences in the allocation of time can be explained by differences in the tax-wedge and wage differentials."
- A special competitiveness panel of the European Commission acknowledged that "many young scientists continue to leave Europe on graduating, notably for the U.S. Too few of the brightest and best from elsewhere in the world choose to live and work in Europe."

Conclusion

One of the most important lessons to be learned is that GDP is linked to policy. For instance, the CBO's long-run forecasts assume that inflation-adjusted GDP will grow by about 2 percent annually, regardless of whether government consumes 21 percent of economic output or 56 percent of economic output. The dismal performance of the European economies shows that this is a deeply flawed assumption and indicates that America's future is at even greater risk than the CBO estimates suggest.

If the United States is saddled with a French-sized government, it will inevitably suffer from French-style economic stagnation. This means higher unemployment, lower living standards, and a loss of upward mobility. The economic malaise in Europe is tragic, but the dark cloud could have a silver lining if policymakers learn the right lesson and protect Americans from that fate by reducing the burden of government—both today and in the future.

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Talking Points

- Left unchecked, the growing burden of government will turn America into an uncompetitive European-style welfare state.
- Evidence from Europe indicates that big government imposes a very high cost. Living standards are much lower in Europe, unemployment is far higher, and growth is anemic.
- Thanks to globalization, it is increasingly easy for labor and capital to cross national borders in a search for better economic policy. This increases the rewards for good policy, but it also boosts the penalty for bad policy.
- Ireland shows that it is possible for European nations to reform. The former "Sick Man of Europe" is now the "Celtic Tiger" thanks to dramatic tax rate reductions and a large reduction in the burden of government spending.

This paper, in its entirety, can be found at: *www.heritage.org/research/budget/bg1979.cfm*

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The federal government spends an enormous amount of money. Measured as a share of national economic output, budgetary outlays are near a peacetime high, consuming almost 21 percent of gross domestic product (GDP).[1] Whether it is measured in nominal dollars, in inflation-adjusted (real) dollars, or on a per household basis, federal spending in America is at record levels.

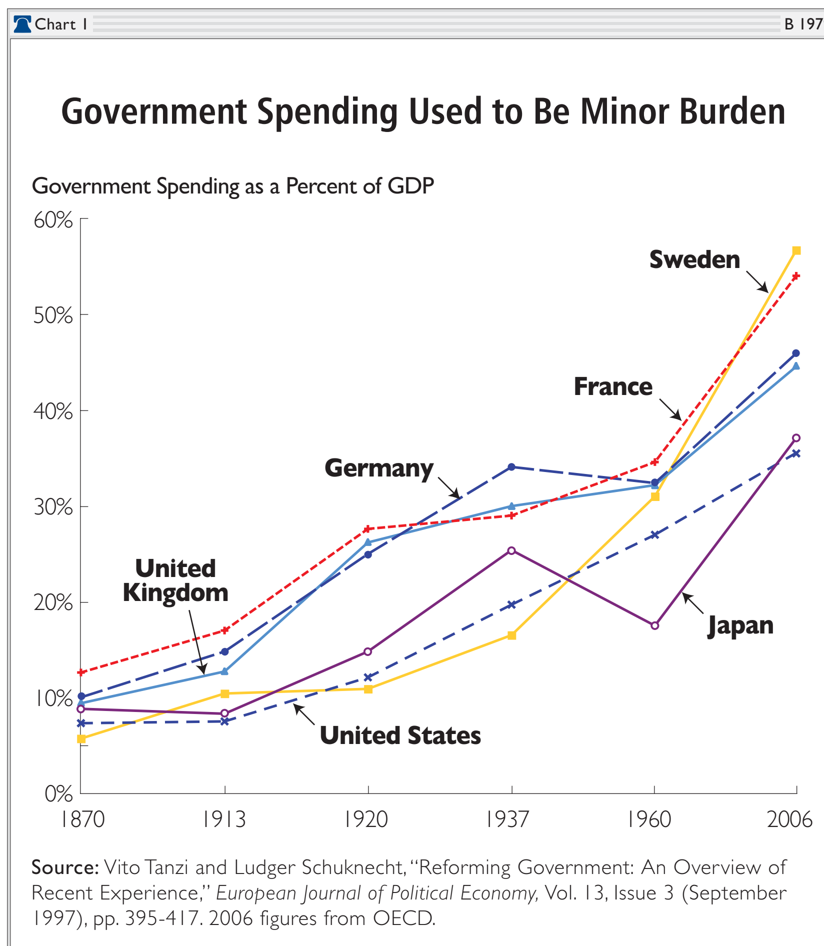
Moreover, this is just the calm before the storm. Left on autopilot, the burden of federal spending will increase dramatically. This is partially due to demographic forces, such as the looming retirement of the baby boom generation, but is also the result of reckless policy choices, such as the creation of a new prescription drug entitlement.

In a worst-case scenario, the Congressional Budget Office (CBO) estimates that government outlays could consume as much as 55.8 percent of GDP by 2050. Even a more optimistic scenario shows that the burden of federal spending will still nearly double, climbing to more than 37 percent of GDP.[2] Furthermore, these figures do not count state and local outlays, which currently consume more than 11 percent of GDP and will probably expand in future years.[3]

Many European nations have already allowed the burden of government to climb to these levels. Government spending consumes more than 50 percent of GDP in France and Sweden and more than 45 percent in Germany and Italy.[4] These nations provide useful lessons about the economic consequences of bigger government, and these lessons suggest that America

is on the wrong track. Even a cursory review of European economic performance shows that excessive government has serious adverse effects: slower growth, higher unemployment, lower living standards, and a bleak future.

One of the most important lessons to be learned is that GDP is linked to policy. For instance, the CBO's long-run forecasts assume that inflation-adjusted GDP will grow by about 2 percent annually, regardless of whether government consumes 21 percent of economic output or 56 percent of economic output. The dismal performance of the European economies shows that this is a deeply flawed assumption and indicates that America's future is at even greater risk than the CBO estimates suggest. Bluntly stated, the United States is in danger of becoming a decrepit welfare state like France.



Source: Vito Tanzi and Ludger Schuknecht, "Reforming Government: An Overview of Recent Experience," *European Journal of Political Economy,* Vol. 13, Issue 3 (September 1997), pp. 395-417. 2006 figures from OECD.

Comparing Europe and the United States

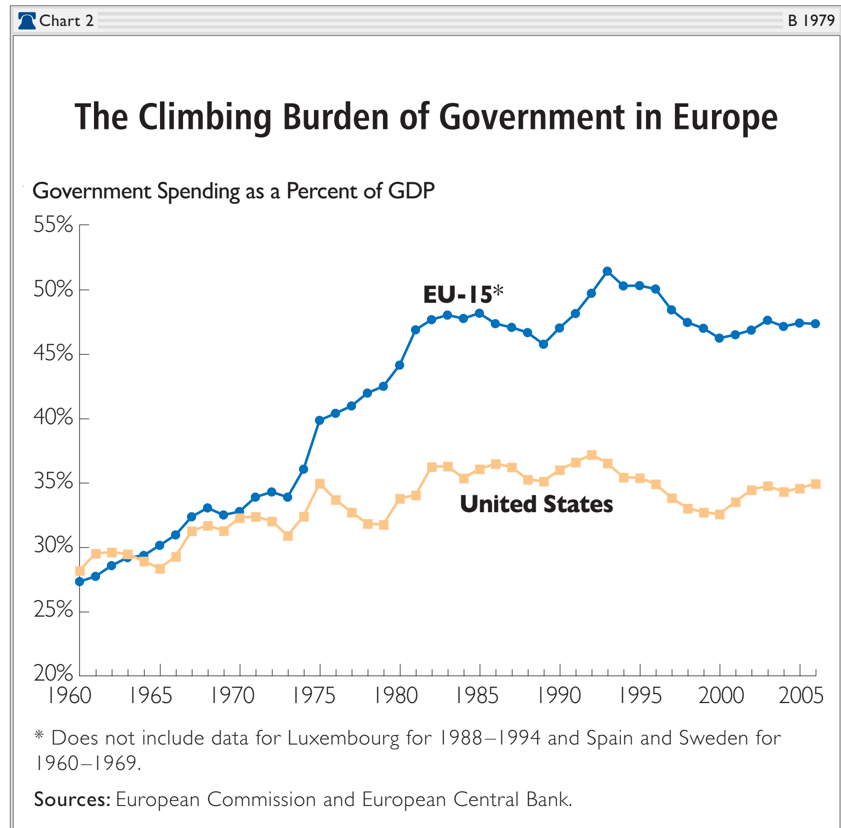
Western Europe[5] and the United States are wealthy, and both achieved this status over the past two centuries in part because of sensible policies and institutions. While much of the world was and still is crippled by the absence of functioning market economies, Europe and the United States have enjoyed centuries of remarkable growth thanks to property rights, the rule of law, and minimal government.

For much of the 19th century, many European nations were richer than the United States. The United Kingdom and the Netherlands at various

1. Office of Management and Budget, *Historical Tables, Budget of the United States Government, Fiscal Year 2007* (Washington, D.C.: U.S. Government Printing Office, 2006), pp. 23–24, Table 1.2, at *www.whitehouse.gov/omb/budget/fy2007/pdf/hist.pdf* (July 19, 2006).
2. Congressional Budget Office, "The Long-Term Budget Outlook," December 2005, p. 12, at *www.cbo.gov/ftpdocs/69xx/doc6982/12-15-LongTermOutlook.pdf* (July 19, 2006).
3. Office of Management and Budget, *Historical Tables*, pp. 312–313, Table 15.3.
4. Organisation for Economic Co-operation and Development, *OECD in Figures*, 2005, at *http://213.253.134.29/oecd/pdfs/browseit/0105061E.pdf* (July 19, 2006).
5. Unless stated otherwise, references to Europe, Western Europe, and the European Union refer to the EU-15: the 15 nations (Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, and the United Kingdom) that comprised the European Union before it expanded. The 10 new member nations (Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia) are not included in statistical comparisons because in most cases they are still recovering from decades of Communist enslavement, and their inclusion would unfairly depress European economic statistics.

times have enjoyed the globe's highest living standards.[6] The United States took the lead in the first half of the 20th century, thanks to strong growth, but also because World War I and World War II caused extensive damage to Europe.

In 1950, the United States had nearly twice the per capita GDP of Western Europe. Over the next two decades, however, European economies enjoyed strong growth.[7] America's advantage shrank, and a number of European nations appeared to be on pace to surpass the United States.



Europe's Shift to Statism

However, Europe and the United States then began to move in opposite directions, and public policy seems to be one of the biggest reasons for the shift. Beginning in the late 1960s and early 1970s, politicians in most European nations increased the size and scope of government. Government also expanded in America during that period, but the increase was more muted. More important, beginning in 1980, America began to liberalize its economy and curtail the growth of government.

As a result of these historical differences, the burden of government in Europe is substantially larger than it is in the United States. Chart 2 shows that the burden of government spending relative to GDP has risen dramatically in Europe, while the U.S. has largely avoided the same mistake.

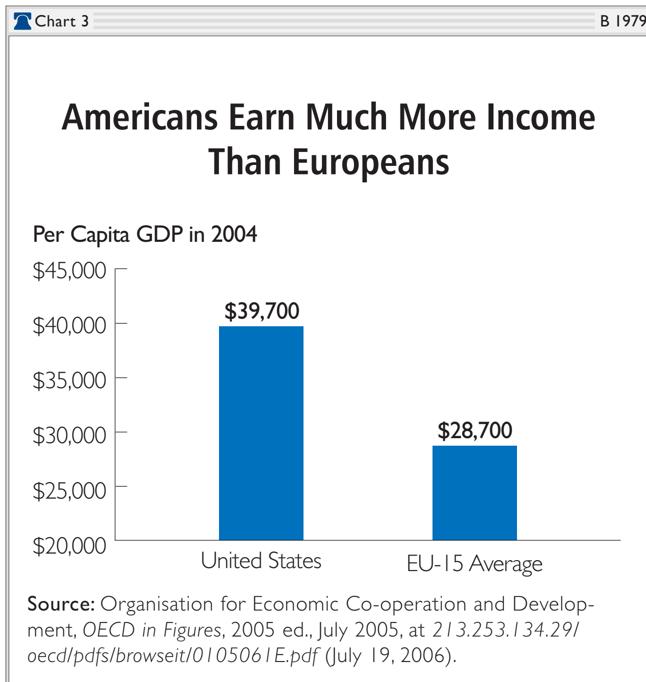
The growth of government in Europe has resulted in considerable economic damage because both spending and taxes undermine incentives to engage in productive behavior. On the spending side of the ledger, bigger government encourages people to rely on handouts rather than individual initiative. On the revenue side, the higher marginal tax rates needed to finance programs reduce incentives to work, save, and invest.

Not surprisingly, these divergent policies resulted in different economic outcomes.[8] Simply stated, the United States is now substantially outperforming

6. Angus Maddison, *The World Economy: A Millennial Perspective* (Paris: Organisation for Economic Co-operation and Development, 2001).

7. A well-established economic theory suggests that living standards will generally converge over time in nations with different levels of income. This assumes, of course, that various nations have similar institutions and policies. For more information, see Nick Vanston, "Summary of a Workshop on Global Convergence Scenarios: Structural and Policy Issues," Organisation for Economic Co-operation and Development, Economics Department *Working Paper* No. 483, May 12, 2006, at *www.olis.oecd.org/olis/2006doc.nsf/43bb6130e5e86e5fc12569fa005d004c/b13adab5b356167bc125717000540aa5/$FILE/JT03208866.pdf* (July 19, 2006).

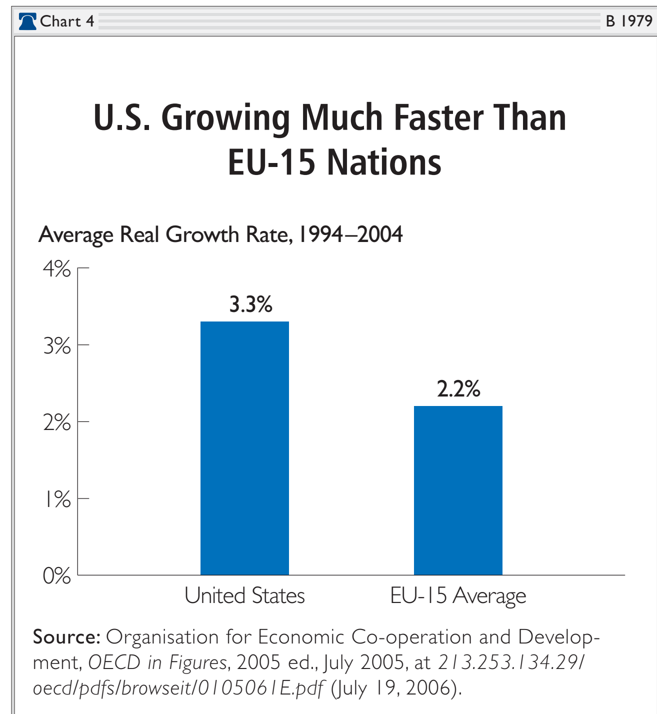
8. While fiscal policy is the major policy difference between the U.S. and Europe, the U.S. has an advantage in a few other areas such as labor regulation.



Source: Organisation for Economic Co-operation and Development, *OECD in Figures*, 2005 ed., July 2005, at *213.253.134.29/oecd/pdfs/browseit/0105061E.pdf* (July 19, 2006).

Europe. As the following statistics indicate, this has dramatic consequences for the economic well-being of citizens on both sides of the Atlantic.

- Per capita economic output in the U.S. in 2003 was $39,700, almost 40 percent higher than the $28,700 average for EU-15 nations.[9] (See Chart 3.)
- Over the past 10 years, the U.S. economy has grown at an average annual rate of 3.3 percent in real terms, 50 percent faster than the EU-15's growth rate of 2.2 percent.[10] (See Chart 4.)
- A report prepared for the European Commission admitted that "since 1996 the average annual growth in EU [European Union] output per head has been 0.4 percentage points below that of the US. From holding its own, Europe is now losing ground."[11]
- The report also acknowledged that "labour productivity in the EU is on a trend growth path which is lower than that of the US. Over the period 1996–2003, the EU-15 productivity growth rate averaged 1.4%, as opposed to 2.2% recorded for the US."[12]
- "In the EU," confesses another European Commission report, "there has been a steady decline of the average growth rate decade after decade and *per-capita* GDP has stagnated at about 70% of the US level since the early 1980s. The disparity between the EU and the US has been particularly remarkable in recent years. For instance, over the period 1995 to 2001, the US economy accounted for over 60% of the cumulative expansion in world GDP, while the EU, with only a slightly smaller economy, contributed less than 10%."[13]
- Americans enjoy more leisure than Europeans because they can afford to purchase labor and goods that reduce the amount of time spent

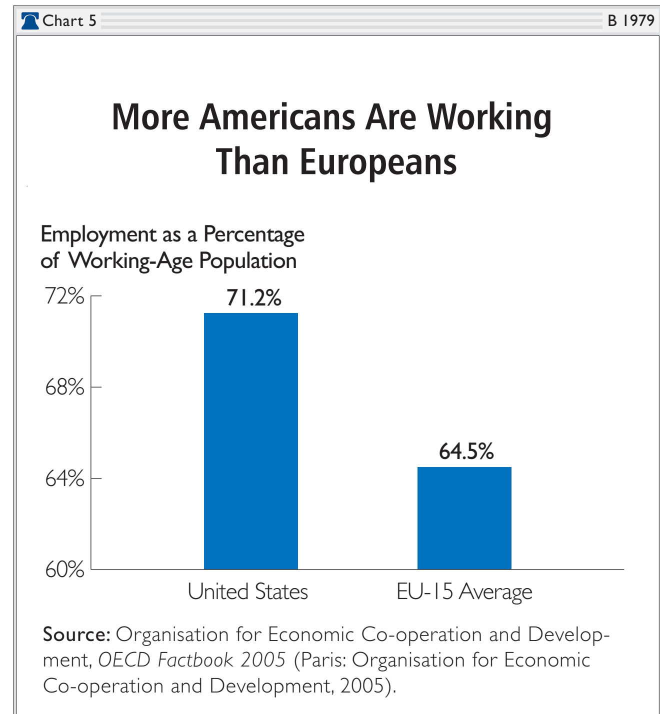


Source: Organisation for Economic Co-operation and Development, *OECD in Figures*, 2005 ed., July 2005, at *213.253.134.29/oecd/pdfs/browseit/0105061E.pdf* (July 19, 2006).

9. Organisation for Economic Co-operation and Development, *OECD in Figures*, 2005, pp. 12–13.
10. *Ibid.*, pp. 14–15.
11. European Commission, "Facing the Challenge: The Lisbon Strategy for Growth and Employment," November 2004, p. 14, at *http://ec.europa.eu/growthandjobs/pdf/kok_report_en.pdf* (September 29, 2006). Also known as the "Kok Report."
12. *Ibid.*

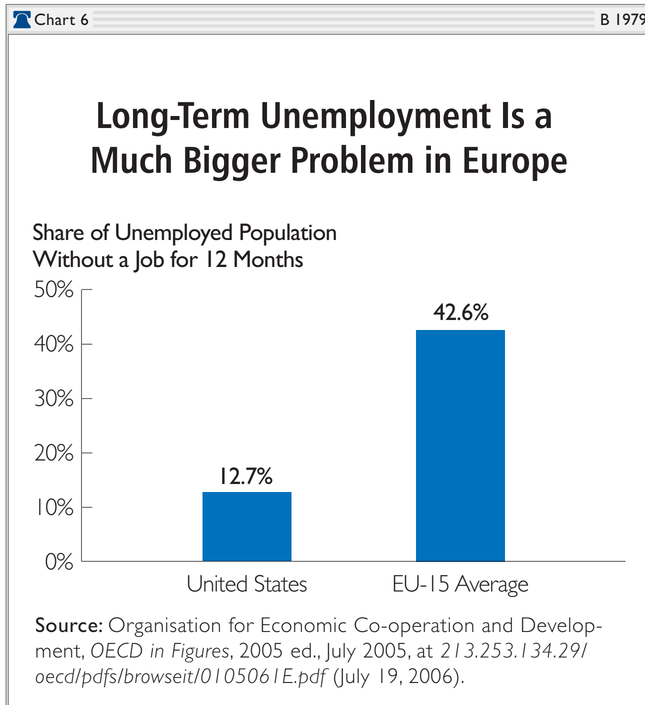
working at home. According to one German study, "overall working time is very similar on both sides of the Atlantic. Americans spend more time on market work but Germans invest more in household production." The report further notes that "these differences in the allocation of time can be explained by differences in the tax-wedge and wage differentials."[14]

- A comparative study by Timbro, a Swedish think tank, found that EU countries would rank with the very poorest American states in terms of living standards, roughly equal to Arkansas and Montana and only slightly ahead of West Virginia and Mississippi, the two poorest states.[15]
- In August 2006, unemployment in the European Union was 8.0 percent, including a 7.9 percent unemployment rate in the group of nations that use the euro. The U.S. unemployment rate in the same month was only 4.7 percent.[16]
- Unemployment rates tell just part of the story because they measure only the number of unemployed compared to the number of those in the labor force. The size of the labor force is an equally important statistic. In the United States, more than 70 percent of the working-age population has a job, compared to less than 65 percent in the European Union.[17] (See Chart 5.)
- Not only is the unemployment rate in the U.S. significantly lower than the EU-15 unemployment rate, but there is also a stunning gap between the percentage of unemployed who have been without a job for more than 12 months—12.7 percent in the U.S. versus 42.6 percent in the EU-15.[18] (See Chart 6.)
- According to an article in *The American Enterprise*, "Since the 1970s, America has created some 57 million new jobs, compared to just 4 million in Europe (with most of those in government)."[19]



Source: Organisation for Economic Co-operation and Development, *OECD Factbook 2005* (Paris: Organisation for Economic Co-operation and Development, 2005).

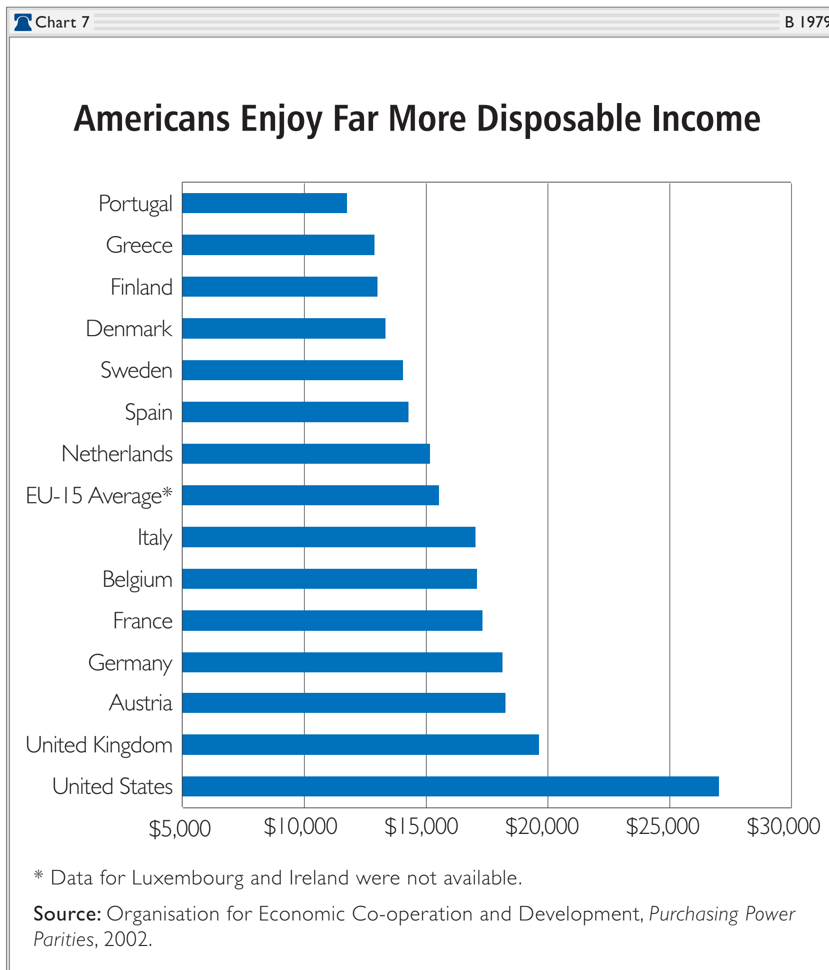
13. Independent High-Level Study Group, *An Agenda for a Growing Europe: Making the EU Economic System Deliver*, European Commission, July 2003, at *www.euractiv.com/ndbtext/innovation/sapirreport.pdf* (July 19, 2006; unavailable September 26, 2006).
14. Ronald Schettkat, "Differences in US–German Time-Allocation: Why Do Americans Work Longer Hours Than Germans?" Institute for the Study of Labor, *Discussion Paper* No. 697, January 2003, at *ftp://repec.iza.org/RePEc/Discussionpaper/dp697.pdf* (July 19, 2006).
15. Fredrick Bergström and Robert Gidehag, "EU vs. USA," Timbro, June 2004, at *www.timbro.com/euvsusa/pdf/EU_vs_USA_English.pdf* (July 20, 2006).
16. News release, "Euro Area Unemployment Up to 7.9%," Eurostat, October 3, 2006, at *epp.eurostat.ec.europa.eu/pls/portal/docs/PAGE/PGP_PRD_CAT_PREREL/PGE_CAT_PREREL_YEAR_2006/PGE_CAT_PREREL_YEAR_2006_MONTH_10/3-03102006-EN-AP.pdf* (October 3, 2006).
17. Organisation for Economic Co-operation and Development, *OECD Factbook 2005* (Paris: Organisation for Economic Co-operation and Development, 2005).
18. Organisation for Economic Co-operation and Development, *OECD in Figures*, 2005.
19. Joel Kotkin, "America Still Beckons," *The American Enterprise*, October–December 2005, at *http://taemag.com/printVersion/print_article.asp?articleID=18720* (July 20, 2006).



Source: Organisation for Economic Co-operation and Development, *OECD in Figures*, 2005 ed., July 2005, at *213.253.134.29/oecd/pdfs/browseit/0105061E.pdf* (July 19, 2006).

- The article also notes that "Europe's best brains are leaving in droves. Some 400,000 E.U. science and technology graduates currently reside in the United States, and barely one in seven, according to a recent European Commission poll, intends to return"; that "European immigration to the United States jumped by some 16 percent during the 1990s"; and that "there are now half a million New York City residents who were born in Europe."[20]
- There are nearly 20 million unemployed in Europe, including nearly 20 percent of those who are under age 25.[21]
- The European Commissioner for Economic and Monetary Affairs admitted, "The most pressing challenges that Europe currently faces are the lack of growth and new jobs, the growing competitive pressures from an integrating world economy.... [T]he EU economy still lacks resilience.... Potential growth remains low at around 2%. Europe's labour force is still grossly underutilised as witnessed by low employment rates as well as high and persistent unemployment."[22]
- A special competitiveness panel of the European Commission acknowledged that "many young scientists continue to leave Europe on graduating, notably for the U.S. Too few of the brightest and best from elsewhere in the world choose to live and work in Europe."[23]
- Thanks in part to lower tax rates and the opportunities created by an economy with less government, "millions of Italians, Irish, Germans, and other Europeans have voted with their feet in favor of America's balance between work and leisure, with no discernable flow in the opposite direction."[24]
- Thanks to higher levels of economic output and lower levels of taxation, Timbro found that the average person in the U.S. enjoys about $9,700 more yearly consumption than the average EU resident, a difference of 77 percent.[25] (See Chart 7.)
- A study found that "American households...have far more domestic appliances, television sets, computers, telephones and cars than in most European countries."[26]

20. *Ibid.*
21. Eurochambres, "Social Europe in a Global Environment," October 2005, at *www.eurochambres.be/PDF/pdf_position_2005/Social%20Europe%20Oct%202005.pdf* (July 20, 2006).
22. Joaquin Almunia, "Economic Governance: Addressing the Challenges," speech at the European Economic and Social Committee Plenary Meeting, Brussels, February 15, 2006, at *http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/06/87* (July 20, 2006).
23. European Commission, "Facing the Challenge," p. 20.
24. Irwin M. Stelzer, "European Holiday," *The Weekly Standard*, September 16, 2003, at *www.weeklystandard.com/Content/Public/Articles/000/000/003/123ezraq.asp* (July 20, 2006).
25. Bergstrom and Gidehag, "EU vs. USA."
26. *Ibid.*



* Data for Luxembourg and Ireland were not available.

Source: Organisation for Economic Co-operation and Development, *Purchasing Power Parities*, 2002.

- Average total dwelling space in Europe is just under 1,000 square feet. In the U.S., it is 1,875 square feet for the average household and 1,200 square feet for poor households. Adjusting for household size, one finds that poor households in the United States have slightly more dwelling space than the average European household. The average poor American has more square footage of living space than does the average person living in London, Paris, Vienna, and Munich.[27]
- British Prime Minister Tony Blair warned the European Parliament, "What type of social model is it that has 20 million unemployed in Europe? Productivity rates falling behind those of the USA? That, on any relative index of a modern economy—skills, R&D [research and development], patents, information technology, is going down, not up."[28]
- A study by Eurochambres estimated how long it would take Europe to catch up to America, assuming no more growth in the U.S. It would take Europe 18 years to reach U.S. income levels, 14 years to reach U.S. levels of productivity per employee, 24 years to reach U.S. levels of R&D investment, and 26 years to reach U.S. employment levels.[29]
- According to German financial reporter Olaf Gersemann, "If labor productivity in Germany and the U.S. continue on the same path as from 1996 to 2003, per capita income in Germany will grow by only 44 percent by the time American incomes double in 2026. Put differently, within a generation, Americans will enjoy twice the economic status that Germans do."[30]
- The Organisation for Economic Co-operation and Development (OECD) admits that Europe is lagging. As reported by *The Wall Street Journal*, "GDP per capita in Germany, France and Italy is falling, relative to the U.S., to levels below those recorded in the 1970s…. 'At current trends, with demographics the way they

27. Robert E. Rector and Kirk A. Johnson, Ph.D., "Understanding Poverty in America," Heritage Foundation *Backgrounder* No. 1713, January 5, 2004, at *www.heritage.org/Research/Welfare/bg1713.cfm*.
28. Olaf Gersemann, "Europe's Not Working," *The American Enterprise*, October–December 2005, at *http://taemag.com/printVersion/print_article.asp?articleID=18719* (July 20, 2006).
29. Eurochambres, "A Business Assessment of the First National Reform Programmes," Spring 2006, at *www.eurochambres.be/PDF/pdf_Lisbon/060123-NAPbusinessAssessment/Final%20Report.pdf* (July 20, 2006).
30. Gersemann, "Europe's Not Working."

are, the average U.S. citizen will be twice as rich as a Frenchman or a German in 20 years,' Jean-Philippe Cotis, chief economist at the OECD, told us."[31]

- In 1980, foreign direct investment in the United States totaled $127 billion, according to the Bureau of Economic Analysis. Today, it totals more than $1.7 trillion. In 1980, there was $90 billion of foreign portfolio investment (just counting holdings of government and private securities) in the United States. Today, there is more than $4.6 trillion.[32] Much of that money—capital that finances new investment—comes from Europe and at least partly reflects the more market-oriented policy environment in the United States.
- As noted by Jean-Claude Trichet, president of the European Central Bank (ECB), "When comparing the euro area's economic performance to the US, there is evidence of increasing disparities in growth. Since the beginning of the 1990s, the gap in per capita income growth between the US and the euro area has continuously widened—by 0.8% on average per year during the 1990s, increasing to 1.3% per year from 2002 onward."[33]
- "Over a period of 20 years," admits Trichet, "we have been the witnesses of a very significant structural change across the Atlantic. From the eighties to the first years of the twenty first century the growth of labour productivity per hour has been multiplied by more than two in the US when it has been divided by two in Europe. Overall in this respect the relative position of the US and of Europe has changed by a factor 4 to the detriment of Europe."[34]
- Women lag behind in Europe. Reporting on a study from the International Labor Organization, *Newsweek* noted that "women account for 45 percent of high-level decision makers in America, including legislators, senior officials and managers across all types of businesses. In the U.K., women hold 33 percent of those jobs. In Sweden—supposedly the very model of global gender equality—they hold 29 percent. Germany comes in at just under 27 percent, and Italian women hold a pathetic 18 percent of power jobs.… Europe is killing its women with kindness—enshrined, ironically, in cushy welfare policies that were created to help them."[35]

These remarkable comparisons show Europe's stagnation and are particularly embarrassing for EU politicians. With great fanfare in March 2000, EU officials committed themselves to the goal that, within 10 years, Europe would "become the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion."[36] The Lisbon Strategy, as it is called, is a noble goal, but Europe has no chance of achieving this goal by 2010.

Indeed, Europe is falling farther behind the United States in terms of per capita economic output. As noted by the head of the European Central Bank, "since the launch in 2000 of the Lisbon strategy, the annual growth rate for the Euro area has averaged 1.8% per year (compared to 2.8% in the US), thus remaining behind its main

31. Editorial, "The European Disease," *The Wall Street Journal*, February 8, 2006.

32. Elena L. Nguyen, "The International Investment Position of the United States at Yearend 2004," U.S. Department of Commerce, Bureau of Economic Analysis *Survey of Current Business*, Vol. 85, No. 7 (July 2005), pp. 38–39, at *www.bea.gov/bea/ARTICLES/2005/07July/0705_IIP_WEB.pdf* (July 21, 2006).

33. Jean-Claude Trichet, "Structural Reforms in Europe," speech at OECD Forum, Paris, May 22, 2006, at *www.ecb.int/press/key/date/2006/html/sp060522_1.en.html* (July 21, 2006).

34. *Ibid.*

35. Rana Foroohar, "Myth & Reality," *Newsweek*, February 27, 2006, at *www.msnbc.msn.com/id/11435567/site/newsweek* (July 21, 2006).

36. European Council, "Presidency Conclusions," March 23–24, 2000, at *www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/ec/00100-r1.en0.htm* (July 21, 2006).

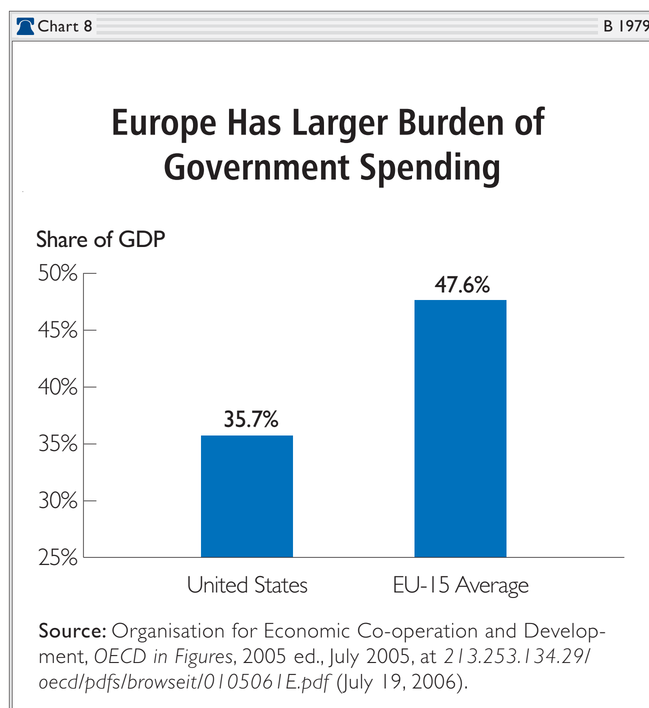
competitor."[37] Politicians in Europe sometimes act as if growth will magically materialize if they form another committee to discuss competitiveness, but others apparently understand what is happening: Only 29 percent of Europeans think the European Union will catch the U.S.[38]

What Is Wrong with Europe

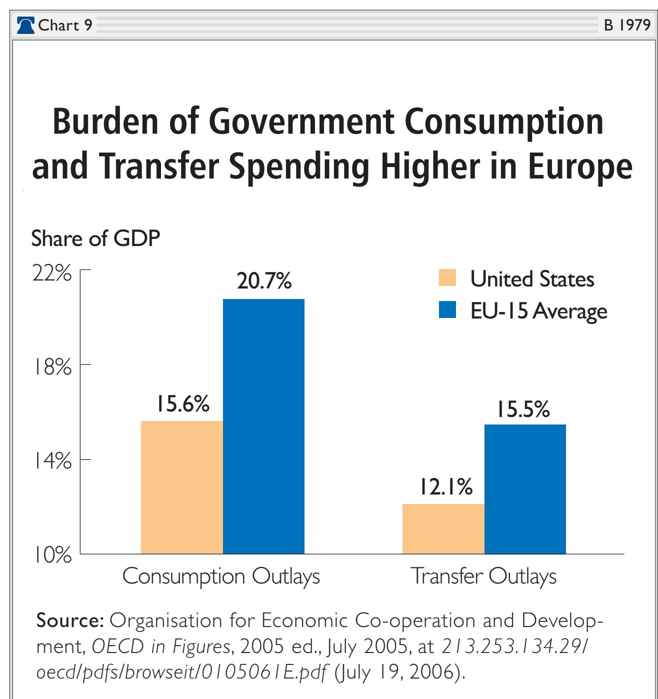
Europe's economy is weak because government is too big. Excessive levels of government spending result in the misallocation of labor and capital for unproductive uses. The taxes needed to finance these counterproductive outlays exacerbate the problem, particularly since many European governments impose high marginal tax rates on work, saving, investment, and entrepreneurship.

Chart 8 shows that government spending consumes nearly 50 percent of economic output in EU nations, compared to 36 percent of GDP in the United States. This is regrettable for Europe since academic research indicates that government spending has an adverse impact on economic performance, particularly when the public sector climbs above 20 percent–25 percent of GDP.[39]

Yet not all forms of government spending are created equal. Some types of outlays, especially government consumption and transfer spending, are particularly harmful to growth. Other outlays—such as those for defense, administration of justice, infrastructure, and education—impose less damage.[40] Europe is further disadvantaged because politicians spend more money on consumption and transfers. As shown in Chart 9, consumption outlays use up nearly 21 percent of GDP, compared to less than 16 percent in the United States. Similarly, transfers consume more than 15 percent of



Source: Organisation for Economic Co-operation and Development, *OECD in Figures*, 2005 ed., July 2005, at *213.253.134.29/oecd/pdfs/browseit/0105061E.pdf* (July 19, 2006).



Source: Organisation for Economic Co-operation and Development, *OECD in Figures*, 2005 ed., July 2005, at *213.253.134.29/oecd/pdfs/browseit/0105061E.pdf* (July 19, 2006).

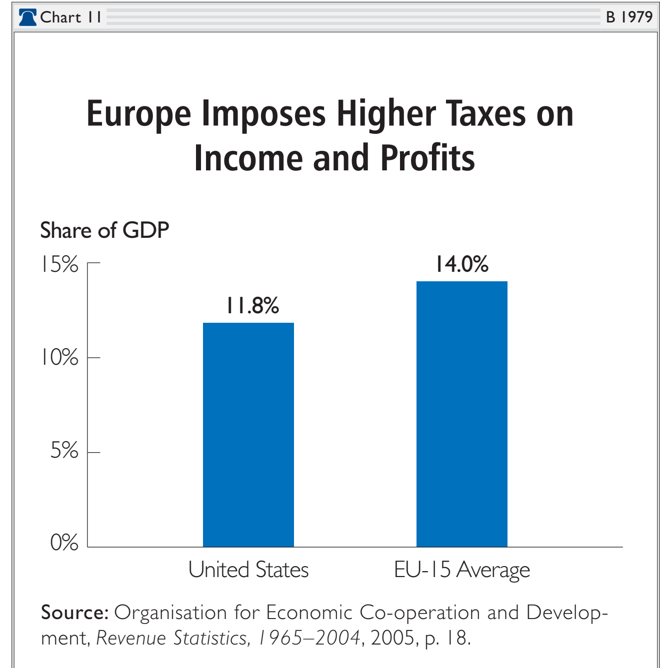
37. Trichet, "Structural Reforms in Europe."
38. Eurochambres, "Social Europe in a Global Environment."
39. Douglas Holtz-Eakin, "The Economic Costs of Federal Spending," testimony before the Committee on the Budget, U.S. Senate, February 16, 2005, at *www.cbo.gov/showdoc.cfm?index=6094&sequence=0* (July 21, 2006).
40. Some forms of government spending contribute to economic growth by facilitating private commerce. For more information, see Daniel J. Mitchell, Ph.D., "The Impact of Government Spending on Economic Growth," Heritage Foundation *Backgrounder* No. 1831, March 15, 2005, at *www.heritage.org/Research/Budget/bg1831.cfm*.

output in the European Union, compared to just 12 percent in the United States.

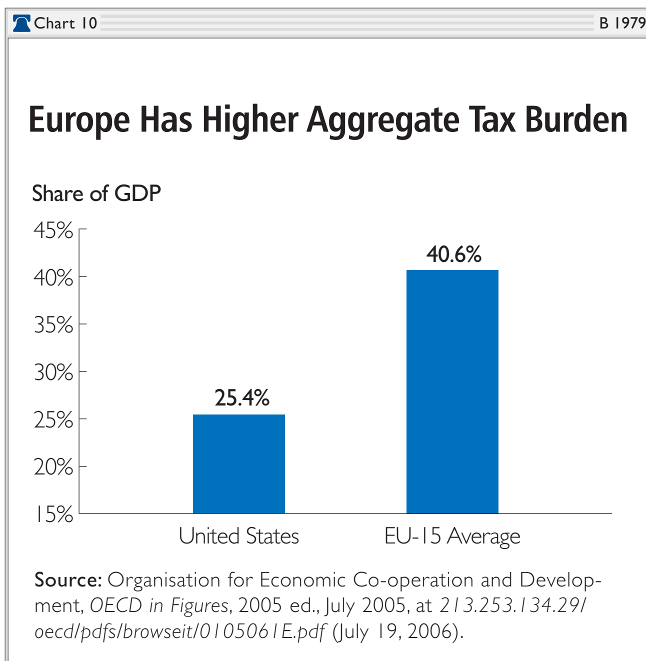
The tax side of the ledger is similarly dismal for Europe. Tax revenues consume more than 40 percent of GDP in European Union nations, compared to about 26 percent in the United States.[41] (See Chart 10.) Just as different types of government spending impose varying degrees of economic damage, the same principle applies for taxation.

Both theory and evidence confirm that taxes on income and profits are the most debilitating to economic performance, followed by payroll taxes. In both cases, European governments have generally made the wrong choices. Taxes on income and profits consume 14 percent of GDP in European Union nations compared to less than 12 percent in the United States. (See Chart 11.) The payroll tax gap is even larger, with such levies consuming almost 12 percent of GDP in Europe compared to less than 7 percent in the United States. (See Chart 12.)

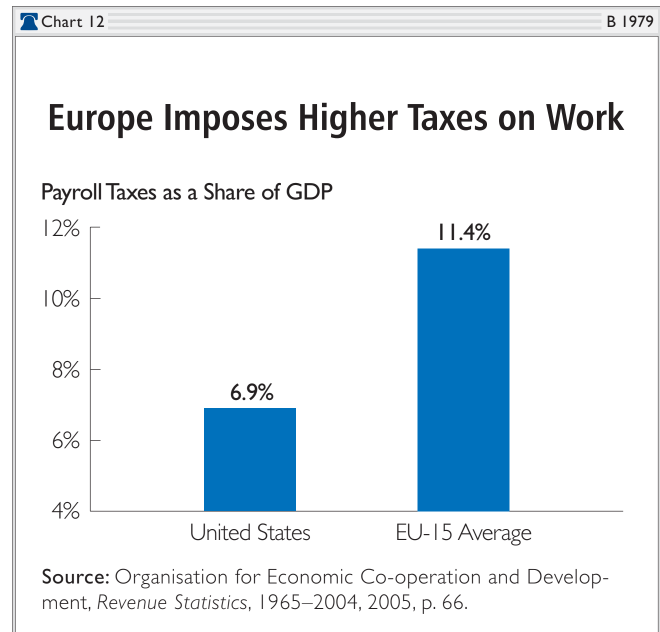
While the overall tax burden is commonly calculated by measuring tax revenues as a share of GDP, this is an imperfect measure. Its biggest shortcoming is that tax rates and tax revenue sometimes have an inverse relationship. If a nation has very high tax rates, taxpayers will have a much greater incentive to change their behavior in ways that reduce taxable income. This Laffer Curve effect means that a nation collects very little revenue in absolute terms



Source: Organisation for Economic Co-operation and Development, *Revenue Statistics, 1965–2004*, 2005, p. 18.



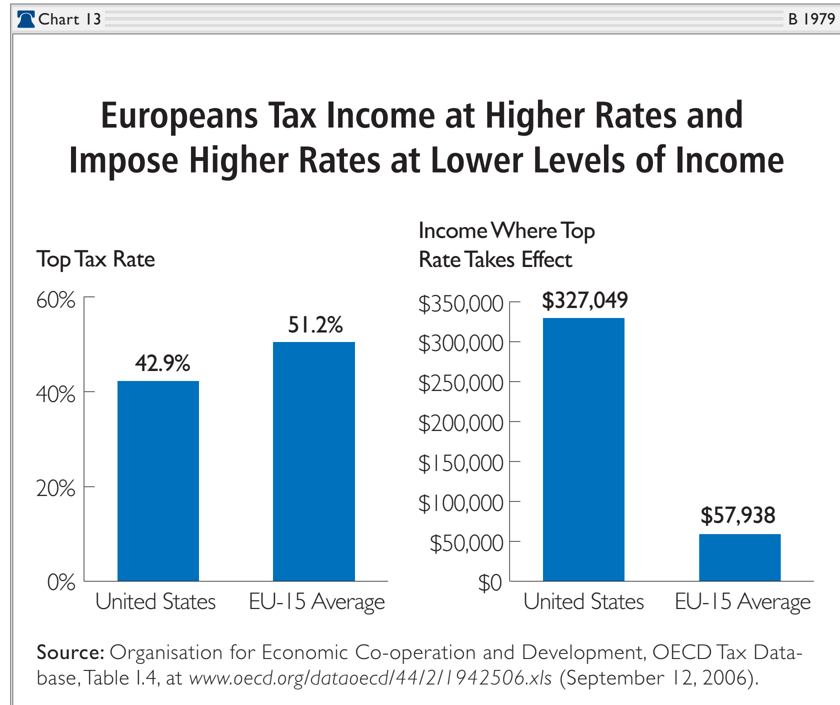
Source: Organisation for Economic Co-operation and Development, *OECD in Figures*, 2005 ed., July 2005, at *213.253.134.29/oecd/pdfs/browseit/0105061E.pdf* (July 19, 2006).



Source: Organisation for Economic Co-operation and Development, *Revenue Statistics*, 1965–2004, 2005, p. 66.

41. Tax revenues include taxes imposed by all levels of government but exclude borrowing and non-tax receipts.

or as a share of GDP, even though the burden of taxation is very high. Ireland and Germany illustrate this phenomenon. Germany has Europe's highest corporate tax rate at 38 percent, yet corporate tax collections are only 1.3 percent of GDP. By contrast, Ireland's 12.5 percent corporate rate generates revenues totaling 3.8 percent of GDP.[42]



Source: Organisation for Economic Co-operation and Development, OECD Tax Database, Table I.4, at *www.oecd.org/dataoecd/44/2/1942506.xls* (September 12, 2006).

Marginal tax rates are a better measure of the tax burden because the disincentive effect of taxation is determined by the tax rate on incremental units of income. For instance, if taxpayers are allowed to earn $40,000 with no tax but then face a 100 percent tax rate on every dollar above that amount, they are highly unlikely to choose to earn more than $40,000 because the marginal tax rate on those additional dollars would be confiscatory. This extreme example highlights the importance of marginal tax rates, which is why the top tax rates on personal income and corporate income are good measures of whether a nation has a competitive tax regime. It is also important to compare the degree to which nations impose extra layers of taxation on income that is saved and invested, since the effective marginal tax rate on that income will be higher if governments are allowed to tax it more than one time. (For a discussion of the argument that Europeans are choosing leisure over work, see Appendix 2.)

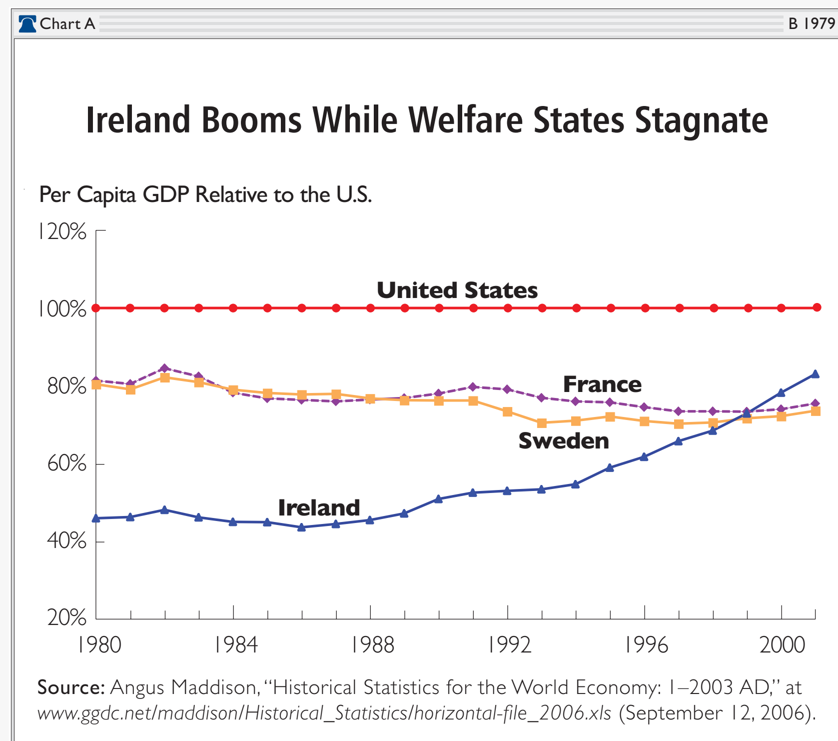
While the United States enjoys a substantial advantage over Europe with regard to the aggregate tax burden, the advantage shrinks when one looks at marginal tax rates on personal income. The average top tax rate in the European Union is nearly 50 percent, which is not that different from the 43 percent top tax rate (including the average of state income tax rates) in the United States. It is worth noting, though, that Americans can choose to live in states that do not impose income taxes, so the 35 percent federal tax rates is the mandatory maximum, although the 2.9 percent Medicare payroll tax pushes the effective marginal tax rate higher.[43] Another interesting feature of the U.S. system is that the top tax rate is not imposed until income reaches more than $325,000. As Chart 13 illustrates, the most punitive tax rates in Europe generally are imposed once income reaches twice the average wage.

42. Organisation for Economic Co-operation and Development, *Revenue Statistics, 1965–2004*, 2005.

43. The Medicare payroll tax applies to all income. Social Security payroll taxes are imposed on income up to $94,200.

Ireland as a Role Model for Europe

By global standards, European nations enjoy comfortable living standards, but this is due largely to strong growth before the expansion of the welfare state. Since then, economic performance has stagnated. Many of these nations now suffer from high unemployment and widespread pessimism about the future, but this does not mean that reform is hopeless. Even France and Germany, Europe's least competitive economies, could restore economic growth by implementing the right policies.



Source: Angus Maddison, "Historical Statistics for the World Economy: 1–2003 AD," at *www.ggdc.net/maddison/Historical_Statistics/horizontal-file_2006.xls* (September 12, 2006).

The role model that they should follow is Ireland. Twenty years ago, Ireland was an economic basket case with double-digit unemployment and an anemic economy. This weak performance was caused partly by an onerous tax burden. The top tax rate on personal income in 1984 was 65 percent, the capital gains taxes reached a maximum of 60 percent, and the corporate tax rate was 50 percent.[44] Then policymakers decided to reduce the burden of government. Tax rates, especially on capital gains and corporate income, were slashed dramatically.[45] Today, the personal income tax rate is 42 percent, the capital gains tax rate is just 20 percent, and the corporate income tax rate is only 12.5 percent.

Supply-side tax cuts were matched by deep reductions in the burden of government spending. As explained in a recent European Central Bank study:

> The so-called "Programme for National Recovery" rested essentially on a deep-rooted expenditure reform. Almost the entire fiscal adjustment during Phase 1 was placed on the spending side, with primary expenditure falling by 12% of GDP over the seven-year period after 1982. In the second phase, public spending fell again by over 10% of GDP. For the total period since 1982, spending even came down by over 20% of GDP to around 35% of GDP in recent years.[46]

44. Irish Department of Finance, Economic and Budget Division, e-mail communication with author, March 29, 2001.

45. For a thorough history of Irish economic reform, see James B. Burnham, "Why Ireland Boomed," *The Independent Review*, Vol. 7, No. 4 (Spring 2003), pp. 537–556, at *www.independent.org/pdf/tir/tir_07_4_burnham.pdf* (July 28, 2006).

46. Sebastian Hauptmeier, Martin Heipertz, and Ludger Schuknecht, "Expenditure Reform in Industrialized Countries: A Case Study Approach," European Central Bank *Working Paper* No. 634, May 2006, at *www.ecb.int/pub/pdf/scpwps/ecbwp634.pdf* (July 28, 2006).

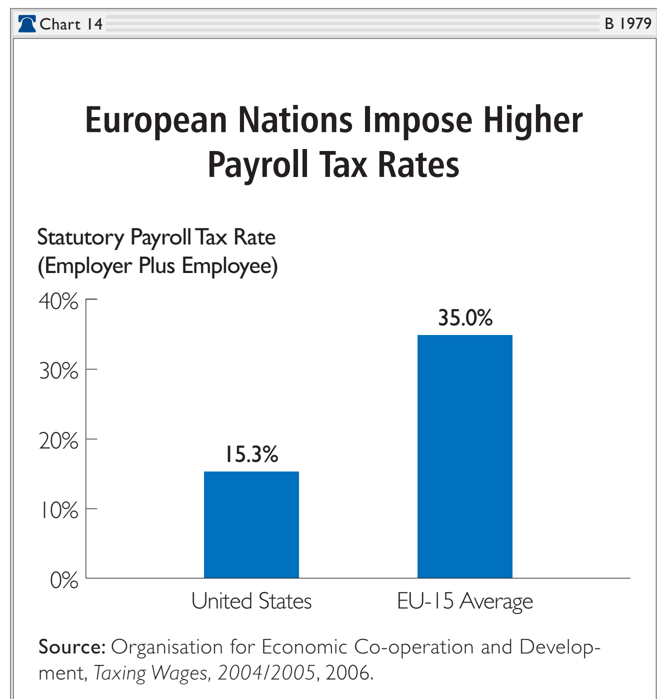
These aggressive free-market reforms yielded enormous benefits. The Irish economy has experienced the strongest growth of all industrialized nations, expanding at an average of 7.7 percent annually during the 1990s.[47] In a remarkably short period of time, the "sick man of Europe" has become the "Celtic Tiger." Unemployment has dropped dramatically, and investment has boomed.[48]

There is every reason to believe that other European nations would enjoy the same results if their politicians were to adopt similar reforms. The accompanying chart shows that free-market policies have led to a dramatic improvement in Irish living standards, whereas European nations that cling to statist policies are gradually losing ground to the United States.

47. Organisation for Economic Co-operation and Development, *OECD in Figures*, 2002, Supplement 1, at *www1.oecd.org/publications/e-book/0102071E.PDF* (July 28, 2006).

48. Benjamin Powell, "Economic Freedom and Growth: The Case of the Celtic Tiger," *The Cato Journal*, Vol. 22, No. 3 (Winter 2003), at *www.cato.org/pubs/journal/cj22n3/cj22n3-3.pdf* (July 28, 2006).

The payroll tax is an area with a more significant American advantage. Payroll tax rates in the United States are 15.3 percent, and the rate falls to 2.9 percent as income climbs above $94,200. In Europe, by contrast, payroll tax rates average more than 30 percent, and those punitive tax rates are often imposed on all income—a policy that undermines the tenuous link between taxes paid and benefits received. (See Chart 14.)

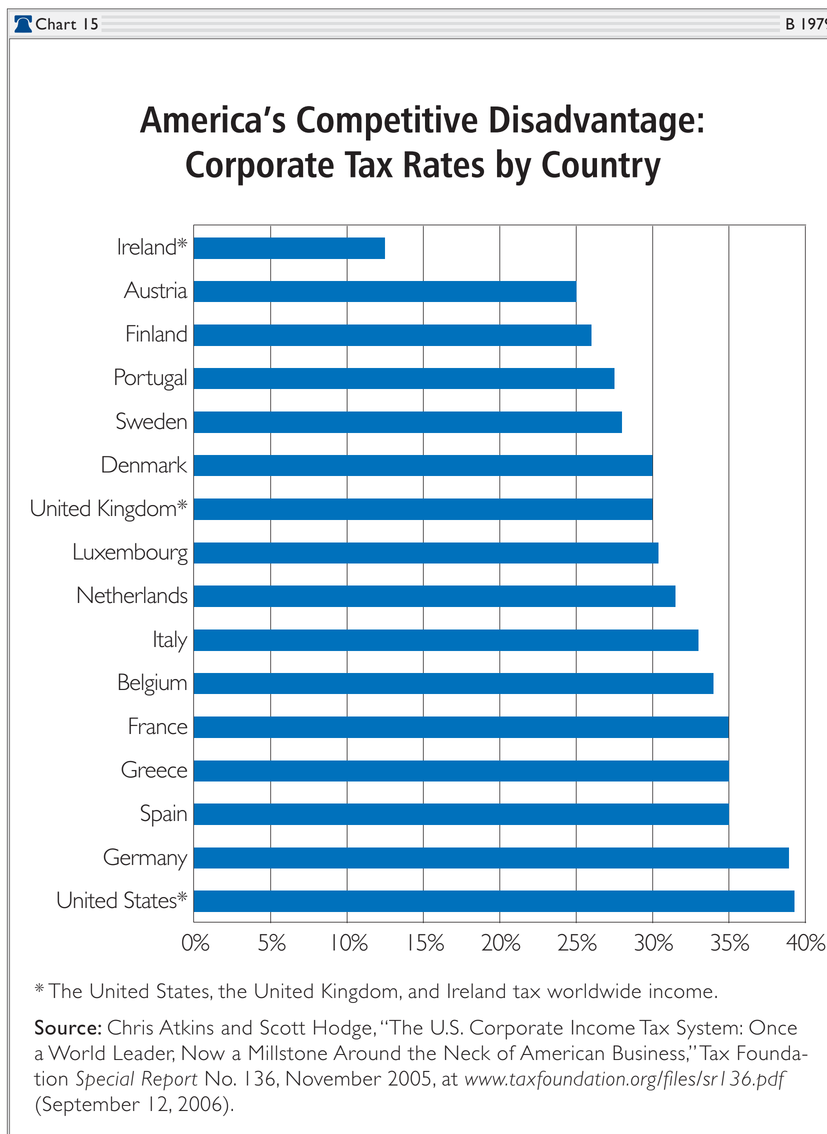


Source: Organisation for Economic Co-operation and Development, *Taxing Wages, 2004/2005*, 2006.

The corporate income tax is one area in which America clearly is at a competitive disadvantage. As shown in Chart 15, the United States has an extraordinarily high corporate tax rate, particularly compared to the average 30 percent tax rate in Europe. The federal rate is 35 percent, and state tax rates (which generally cannot be avoided since states tax corporate income using formulas based on characteristics such as sales or assets) push the total tax rate closer to 40 percent. Moreover, the United States is one of the few nations that impose an additional layer of tax on companies that compete in global markets. As indicated in Chart 15, a handful of other nations impose "worldwide taxation," but U.S. rules are the most onerous.

Like many other nations, the United States imposes double taxation on some forms of income. For instance, income from equity investment is routinely subjected to extra layers of tax. Income is first taxed at the corporate level, as discussed above. If the after-tax income is invested in the company, the increase in the company's value is taxed by the capital gains tax. If the after-tax income is distributed to shareholders, it is subject to the dividend tax. The good news is that Bush tax cuts reduced the double taxation of both dividends and capital gains to 15 percent. However, even with that much-needed reform, America still suffers from a competitive disadvantage. (See Chart 16.)

Finally, the United States imposes a much smaller tax burden on consumption. European Union nations are required to levy a value-added tax (a comprehensive form of national sales tax) of at least 15 percent, and the average tax rate is 19.8 percent. The United States has no equivalent tax. Sales taxes exist in 45 states, but the rates average 5 percent, and these levies are usually imposed on a rather narrow base, leaving substantial shares of consumption untaxed. (See Chart 17.)



* The United States, the United Kingdom, and Ireland tax worldwide income.

Source: Chris Atkins and Scott Hodge, "The U.S. Corporate Income Tax System: Once a World Leader, Now a Millstone Around the Neck of American Business," Tax Foundation *Special Report* No. 136, November 2005, at *www.taxfoundation.org/files/sr136.pdf* (September 12, 2006).

The Role of Other Policy Choices

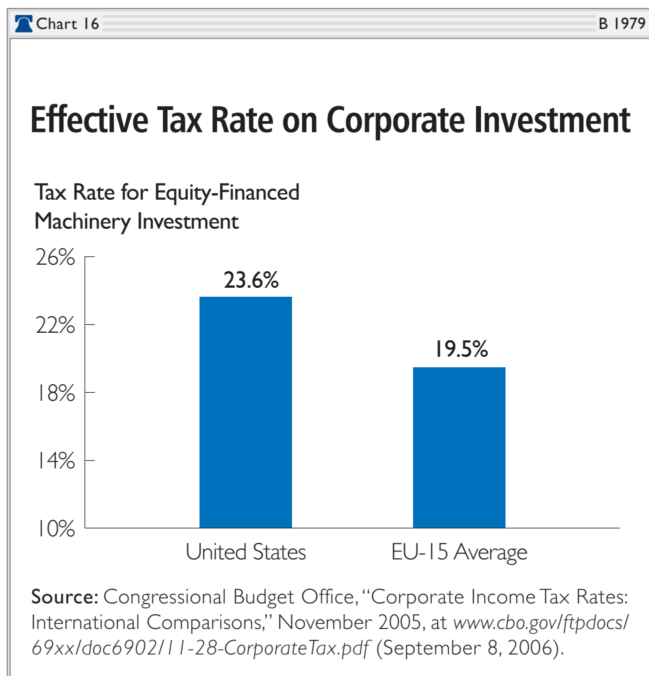
Fiscal policy is one of many factors that affect economic performance. Trade, regulatory, monetary, environmental, and labor policies are just a few of the other factors that determine competitiveness. As discussed, Europe suffers from slow growth, and most European nations have large public sectors. Could these factors be unrelated? Is it possible that Europe's stagnation is the result of non-fiscal policy choices?

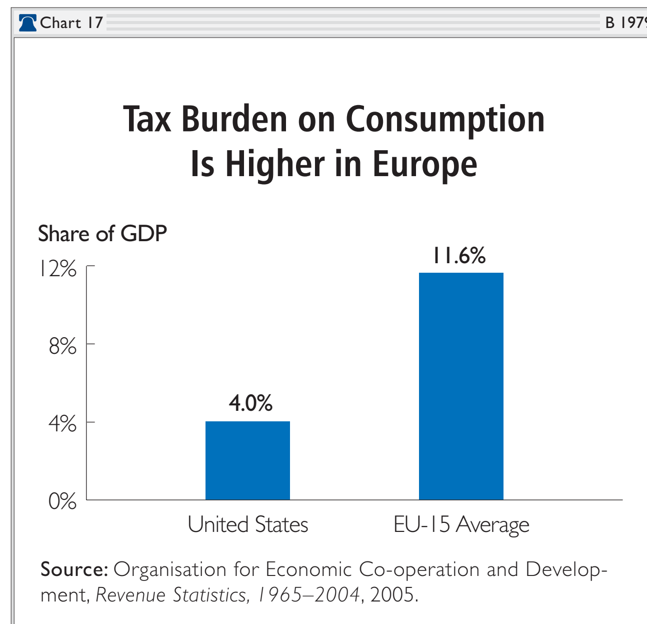
Certainly, fiscal policy is just one of the factors that determine economic performance, and some evidence suggests that some European nations are suffering from excessive government intervention. Yet the relevant question is whether non-fiscal policy mistakes are responsible for the gap between Europe and the United States. The answer almost surely is no. According to the *Index of Economic Freedom*, every EU country is at least somewhat market-oriented, earning a ranking of either "free" or "mostly free." If the fiscal policy variables are removed from the equation, one-third of the EU-15 nations actually have more economic freedom than the United States.[49] (See Chart 18.)

The biggest non-fiscal policy impediment to European competitiveness is probably labor regulation. Chart 19 shows that the burden of labor regulation is particularly severe in Europe. By contrast, European nations tend to be more laissez-faire in their approach to business regulation. (See Chart 19.)

Excessive regulation is partly responsible for Europe's anemic economic performance, but even the nations with relatively market-oriented regula-

49. Marc A. Miles, Kim R. Holmes, and Mary Anastasia O'Grady, *2006 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2006), at *www.heritage.org/index* (July 28, 2006).





tory systems enjoy less prosperity than the United States. (For a discussion of the deficiencies of the "Scandinavian model," see Appendix 1.) High taxes and burdensome spending surely explain much of the gap between the United States and Europe. As the next section explains, big government and economic vibrancy are incompatible.

Learning from Europe's Decline

The United States can learn much from Europe. First and foremost, Europe serves as a warning about the consequences of big government. If American politicians allow the welfare state to expand, economic performance will suffer. Since demographic pressures and misguided policies have put America on a path toward much bigger government, this is a particularly timely warning. Simply stated, a French-size government will mean French-style stagnation.

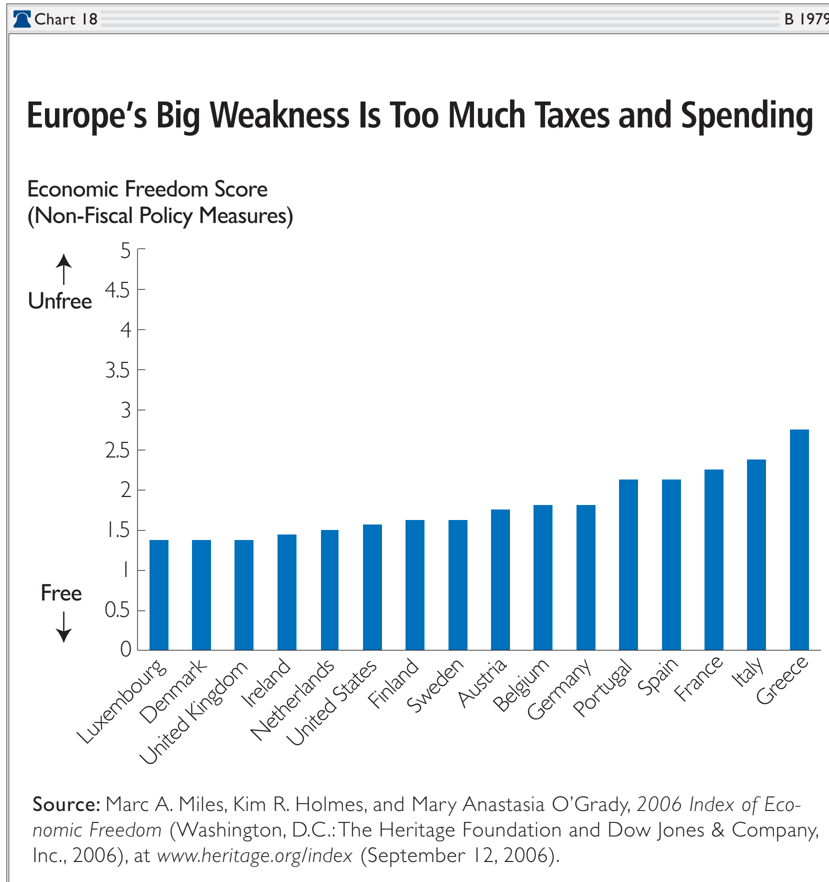
A larger government would have a debilitating impact on American competitiveness. Research clearly demonstrates that America's advantage is due to a smaller burden of government. According to Nobel Laureate Edward Prescott:

> Americans now work 50 percent more than do the Germans, French, and Italians. This was not the case in the early 1970s when the Western Europeans worked more than the Americans…when European and U.S. tax rates were comparable, [and] European and U.S. labor supplies were roughly equal.… [V]irtually all the large differences in the U.S. labor supply and those of Germany and France are due to differences in tax systems.[50]

Prescott also explains that "low labor supplies in Germany, France, and Italy are due to high tax rates. In these countries if someone works more and produces 100 additional euros of output, that individual gets to consume only 40 euros of additional consumption and pays directly or indirectly 60 euros in taxes."[51] Needless to say, there is every reason to think that onerous taxes in the United States would have a similar impact on employment levels.

50. Edward C. Prescott, "Why Do Americans Work So Much More Than Europeans?" Federal Reserve Bank of Minneapolis, Research Department *Staff Report* No. 321, November 2003.

51. *Ibid.*



Source: Marc A. Miles, Kim R. Holmes, and Mary Anastasia O'Grady, *2006 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2006), at *www.heritage.org/index* (September 12, 2006).

European scholars reach similar conclusions. As a study published by the European Central Bank noted:

> It is a well established conclusion, supported by both theory and empirical work, that, once a tax administration is in place, the marginal cost of tax revenue is generally higher than the average cost, and that marginal costs can increase rapidly.… [T]he true cost to the economy of the marginal dollar collected in taxes can significantly exceed the dollar received by the government.… Each additional dollar of spending, requiring an additional dollar of revenue, will impose additional and rising marginal costs on the economy unless that dollar comes from reducing some other spending.[52]

OECD economists have also found that high tax rates impose serious damage. A 1997 study found that "the increase in the average (weighted) tax rate of about 10 percentage points over the past 35 years may have reduced OECD annual growth rates by about ½ percentage point."[53] According to a 2001 study, "The overall tax burden is found to have a negative impact on output per capita. Furthermore, controlling for the overall tax burden, there is an additional negative effect coming from an extensive reliance of direct taxes."[54]

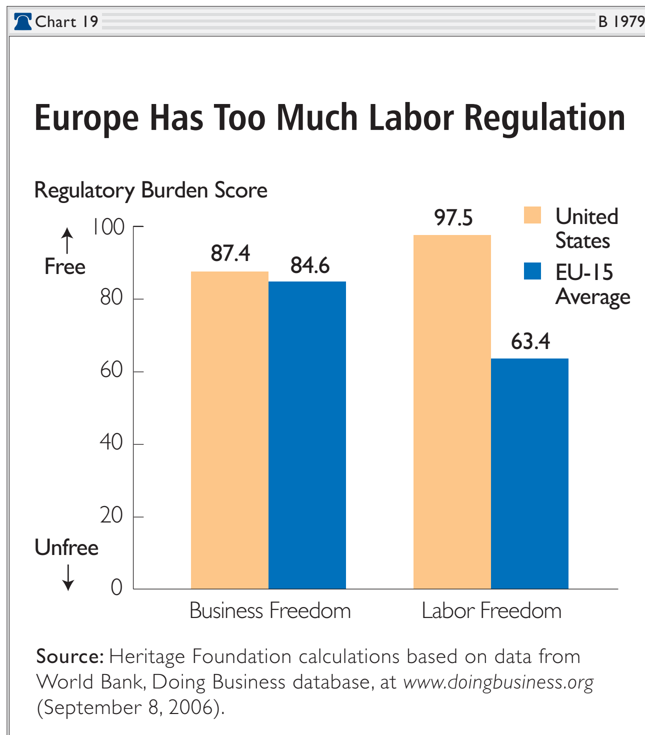
The adverse impact is not just the result of high taxes. An ECB study explains the negative impact of excessive spending:

> The best overall fit would probably be an inverted U that has its maximum somewhere in the low 30 percent of GDP expenditure range. Indeed, there is illustrative evidence of a negative relation between rising public expenditure and economic growth from about this range, as we get a correlation coefficient of –0.56 when we correlate public spending-to-GDP ratios against real GDP growth for all countries with public spending above 30 percent of GDP.[55]

52. António Afonso, Ludger Schuknecht, and Vito Tanzi, "Public Sector Efficiency: Evidence for New EU Member States and Emerging Markets," European Central Bank *Working Paper* No. 581, January 2006, at *www.ecb.int/pub/pdf/scpwps/ecbwp581.pdf* (July 28, 2006).

53. Willi Leibfritz, John Thornton, and Alexandra Bibbee, "Taxation and Economic Performance," Organisation for Economic Co-operation and Development, Economics Department *Working Paper* No. 176, 1997, at *www.oecd.org/dataoecd/33/25/1863834.pdf* (July 28, 2006).

54. Andrea Bassanini and Stefano Scarpetta, "The Driving Forces of Economic Growth: Panel Data Evidence for the OECD Countries," Organisation for Economic Co-operation and Development *Economic Studies* No. 33, November 2001, p. 30, at *www.oecd.org/dataoecd/26/2/18450995.pdf* (July 28, 2006).



Source: Heritage Foundation calculations based on data from World Bank, Doing Business database, at *www.doingbusiness.org* (September 8, 2006).

Another ECB study found specifically that government spending undermines economic growth:

> The illustration of the growth-spending dynamics in the very long run shows a strong correlation between total spending increases and growth declines. The same applies for a similar plot of gross fixed capital formation (one of the main growth determinants) and public spending ratios in the 1990s, i.e. in the medium term. Economy-wide capital formation is strongly and negatively correlated with total government expenditure.[56]

Not surprisingly, ECB researchers have also discovered that economies perform better when the burden of government shrinks:

> Ambitious reform episodes appear to coincide with more lasting fiscal consolidation…while also yielding an important "tax cut dividend". Ambitious reformers also experience a considerably more favourable growth performance.[57]

Interestingly, even the European Commission seems to recognize the importance of smaller government. In a 2003 study, the Commission stated that "budgetary consolidation has a positive impact on output in the medium run if it takes place in the form of expenditure retrenchment rather than tax increases."[58] Moreover, "Fiscal adjustments based on expenditure cuts rather than tax increases have expansionary effects."[59]

OECD economists concur. According to research published in 2001:

> Taxes and government expenditures affect growth both directly and indirectly through investment. An increase of about one percentage point in the tax pressure—*e.g.* two-thirds of what was observed over the past decade in the OECD sample—could be associated with a direct reduction of about 0.3 per cent in output per capita. If the investment effect is taken into account, the overall reduction would be about 0.6–0.7 per cent.[60]

Reform or Stagnation?

Globalization makes good economic policy much more important because it is increasingly easy for jobs and investment to migrate from high-tax nations to low-tax nations. This is a critical

55. Afonso *et al.*, "Public Sector Efficiency."

56. António Afonso, Werner Ebert, Ludger Schuknecht, and Michael Thöne, "Quality of Public Finances and Growth," European Central Bank *Working Paper* No. 438, February 2005, pp. 22–23, at *www.ecb.int/pub/pdf/scpwps/ecbwp438.pdf* (July 28, 2006).

57. Hauptmeier *et al.*, "Expenditure Reform in Industrialized Countries."

58. European Commission, "Public Finances in EMU: 2003," *European Economy*, No. 3 (2003), at *http://europa.eu.int/comm/economy_finance/publications/european_economy/2003/ee303en.pdf* (July 28, 2006).

59. *Ibid.*

60. Bassanini and Scarpetta, "The Driving Forces of Economic Growth," p. 35.

challenge for many EU nations. They already are being pressured because capital and labor ("brain drain") are shifting to the United States, and now they also must worry about reformist nations in Europe, including Ireland in Western Europe and Estonia and Slovakia in Central Europe.

Jurisdictional competition increases the penalty for bad policy, but globalization also increases the rewards for good policy. If the politicians in Europe's stagnant welfare states choose reform, their nations can experience an economic renaissance.

Ironically, rather than reform, some of Europe's politicians are fighting globalization. Working through international bureaucracies such as the European Commission,[61] the OECD,[62] and the United Nations,[63] these politicians are advocating tax harmonization policies to hinder the flow of jobs and capital from high-tax nations to low-tax jurisdictions.

In effect, these misguided proposals would export Europe's uncompetitive fiscal policy to the rest of the world. Tax competition benefits the global economy—a process that should be celebrated rather than persecuted. Indeed, even though the OECD has been leading a campaign for tax harmonization, its economists have admitted that "the ability to choose the location of economic activity offsets shortcomings in government budgeting processes, limiting a tendency to spend and tax excessively."[64] An ECB study likewise warns:

> The importance of the efficient use of public resources and high-quality fiscal policies for economic growth and stability and for individual well-being has been brought to the forefront by a number of developments over the past decades.… Globalisation makes capital and taxpayers more mobile and exerts pressure on governments' revenue base.[65]

Several Nobel Prize winners have commented specifically on tax competition. For example:

- James Buchanan has pointed out that "the intergovernmental competition that a genuinely federal structure offers may be constitutionally 'efficient'" and that "tax competition among separate units…is an objective to be sought in its own right."[66]
- According to Milton Friedman, "Competition among national governments in the public services they provide and in the taxes they impose is every bit as productive as competition among individuals or enterprises in the goods and services they offer for sale and the prices at which they offer them."[67]
- Gary Becker has observed that "competition among nations tends to produce a race to the top rather than to the bottom by limiting the ability of powerful and voracious groups and politicians in each nation to impose their will at the expense of the interests of the vast majority of their populations."[68]

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61. The European Commission has pushed a number of tax harmonization schemes in recent years. For example, see Council of the European Union, Directive 2003/48/EC, June 3, 2003, at *http://eur-lex.europa.eu/LexUriServ/site/en/oj/2003/l_157/l_15720030626en00380048.pdf* (July 28, 2006).
62. See Organisation for Economic Co-operation and Development, "Harmful Tax Competition: An Emerging Global Issue," April 9, 1998, at *www.oecd.org/daf/fa/harm_tax/Report_En.pdf* (July 28, 2006).
63. For the text of a U.N. tax harmonization proposal, see U.N. General Assembly, "High-Level International Intergovernmental Consideration of Financing for Development," June 26, 2001, at *www.un.org/esa/ffd/a55-1000.pdf* (July 28, 2006).
64. Organisation for Economic Co-operation and Development, *Economic Outlook*, No. 63 (June 1998).
65. Afonso *et al.*, "Public Sector Efficiency."
66. Geoffrey Brennan and James Buchanan, *The Power to Tax: Analytical Foundations of a Fiscal Constitution* (Cambridge, U.K.: Cambridge University Press, 1980).
67. Milton Friedman, letter to Center for Freedom and Prosperity, 2001, at *www.freedomandprosperity.org/update/u05-15-01/u05-15-01.shtml#3* (July 28, 2006).
68. Gary Becker, "What's Wrong with a Centralized Europe? Plenty," *Business Week*, June 29, 1998.

Conclusion

Europe is stagnant and is losing its ability to compete in the global economy. Crippling levels of government taxes and spending have undermined the economic prospects of its major economies. Moreover, demographic trends suggest that the burden of government will become even more onerous in the future, although there is some hope that tax competition will force the necessary reductions in the size of the public sector. (See Appendix 3.)

The United States is in a much stronger economic position, largely because its burden of government is significantly smaller. America also has a modest advantage over some European nations because the burden of regulation is less onerous. Yet the key difference between the United States and Europe is the size of government, and it shows that big government imposes a heavy economic cost. Since the burden of government is smaller in the U.S., Americans enjoy more prosperity.

The demographic forces pushing Europe in the wrong direction also exist in America. The retirement of the baby-boom generation threatens to increase the share of economic output that is consumed by federal spending substantially, and recent decisions to expand entitlement programs have made a bad situation even worse. Left on autopilot, federal spending will climb from 21 percent of GDP to at least 37 percent of GDP. Moreover, even these dismal projections tell only part of the story because they exclude state and local government spending (currently 11 percent of GDP) and naively assume that the growing burden of government will not adversely affect GDP growth.

If the United States is saddled with a French-sized government, it will inevitably suffer from French-style economic stagnation. This means higher unemployment, lower living standards, and a loss of upward mobility. The economic malaise in Europe is tragic, but the dark cloud could have a silver lining if policymakers learn the right lesson and protect Americans from that fate by reducing the burden of government—both today and in the future.

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APPENDIX 1
SCANDINAVIA IS NOT A ROLE MODEL

Some argue that inefficient government, not big government, is the problem. Proponents of this view frequently cite the "Scandinavian model,"[69] which they claim combines both efficiency and equity.[70] Scandinavian nations certainly are among the world's richest nations, but the relevant question is how they became rich and whether the welfare state aids or hinders their economic performance.

Scandinavian nations generally enjoy considerable economic freedom. According to the *Index of Economic Freedom*, Scandinavian EU members rank 8th (Denmark), 13th (Finland), and 20th (Sweden) in the world. Non-EU Scandinavian nations rank 5th (Iceland) and 31st (Norway).[71] In other words, Scandinavian nations are market-oriented. With the exception of fiscal policy, they score high. So it is hardly surprising that they are among the world's wealthiest nations.

Yet how would they rank if there were no welfare state? Almost surely, the expansion of government in the 1960s and 1970s exacted a high price. As noted by a Belgian think tank:

> In 1970, Sweden's level of prosperity was one quarter above Belgium's. By 2003 Sweden had fallen to 14th place from 5th in the prosperity index, two places behind Belgium. According to OECD figures, Denmark was the 3rd most prosperous economy in the world in 1970, immediately behind Switzerland and the United States. In 2003, Denmark was 7th. Finland did badly as well. From 1989 to 2003, while Ireland rose from 21st to 4th place, Finland fell from 9th to 15th place.[72]

Sweden is often cited as the main role model, but Swedish economists are not so sanguine. The director of Timbro warns:

> There are nine million people in Sweden, and some 1.5 million people of working age don't go to a job. The unofficial total unemployment is some 20 percent. In the EU-15 between 1995 and 2003, employment grew more in 11 EU countries than in Sweden. In 2004, according to UNCTAD [the United Nations Conference on Trade and Development], only 12 countries out of 183 in the survey had a net outflow of investments—the basis for any job creation—and one of them was Sweden.[73]

The Swedes still enjoy high living standards, but this is largely because of rapid growth before implementation of the welfare state. As one examination of the Scandinavian model noted:

> Between 1890–1950, [Sweden] had one of the highest growth rates in the world, with an average tax burden (taxes collected as a percentage of gross domestic product) of 10–20%. This period explains much of today's wealth. Of Sweden's 50 largest companies, only one was started after 1970. That's no big surprise as by 1980, the average tax burden had reached 50% (where it

69. Tine Dhont and Freddy Heylen, "Fiscal Policy, Employment and Growth: Why Is the Euro Area Lagging Behind?" Ghent University *Working Paper*, November 2004, at *www.feb.ugent.be/fac/research/WP/Papers/wp_04_275.pdf* (July 28, 2006).

70. Andre Sapir, "Globalisation and the Reform of European Social Models," Bruegel *Policy Brief* No. 2005/01, November 2005, at *www.bruegel.org/doc_pdf_120* (July 28, 2006).

71. For country-specific data, see Miles *et al.*, *2006 Index of Economic Freedom*.

72. Martin De Vlieghere, Paul Vreymans, and Willy De Wit, "The Myth of the Scandinavian Model," *The Brussels Journal*, November 25, 2005, at *www.brusselsjournal.com/node/510* (July 28, 2006).

73. Johnny Munkhammar, "Hot Swedish Models," *TCS Daily*, March 1, 2006, at *www.tcsdaily.com/article.aspx?id=030106D* (July 28, 2006).

> remains today) while the labor market became highly regulated and the size of the welfare state reached epic proportions. Sweden would pay dearly for these follies. According to the OECD, the country's per capita GDP ranking slid from fourth place in 1970 to 13th place today. Officially, unemployment hovers around 6% but once all those on sick-leave, early retirement or otherwise subsisting on state aid are included, the figure balloons to around 20%. Between 1995–2003, 11 of the EU-15 countries saw greater employment growth than Sweden.[74]

Even Denmark, the most market-oriented Scandinavian nation, is lagging. "In 1970, in terms of GDP per head," according to the same source, "Denmark was the world's third richest country, surpassed only by the U.S. and Switzerland. In 2003—after more than 30 years of expanding welfare statism—Denmark dropped to seventh."[75]

Interestingly, even the Scandinavians understand that government has become too big. With the exception of Norway, which uses oil revenues to finance much of its welfare state, the burden of government has been reduced substantially. To be sure, the reductions started from very high levels, and the welfare state is still very large, but the trend is in the right direction. An ECB study reported the following about the Swedish and Finnish experiences:

> The [Swedish] public expenditure ratio had increased to a staggering 73% of GDP in 1993 while deficits exceeded 10% of GDP and public debt had risen rapidly to over 70% of GDP.
>
> **Fiscal reforms** started in earnest after 1993 when the government passed three successive "consolidation packages". The strategy proved successful due to discretionary measures that combined revenue-enhancing tax increases with substantial reductions of public expenditure by almost 16 percentage points in the course of seven years. As fiscal balances improved and turned into surpluses, public debt also started coming down rapidly….
>
> Finland started its reforms in a very difficult economic and fiscal environment. Following the end of the late 1980s bubble-economy and the disruption of trade with the Soviet Union, the country experienced a severe economic slump, which lasted from 1990 to mid-1993. GDP fell by almost 15% and unemployment rose to 19%. On the back of rising welfare spending and falling revenue, the spending ratio had reached nearly 65% of GDP and the deficit exceeded 7% while bailout costs for the banking sector further accelerated the increase in the public debt ratio.
>
> In these circumstances, Finland undertook an **ambitious expenditure reform program**…. Primary spending growth of the central government was brought under control and was reduced successively. This resulted in a restrictive fiscal stance after 1994 when the measures started to bite fully. Total expenditure was reduced by 5% of GDP in the course of 2 years and by 15% of GDP to 49% of GDP over seven years. In the same time span, the fiscal balance improved by 14% of GDP to a surplus of 7% (including extraordinary revenue of 2% of GDP in that year). With fiscal consolidation and reviving growth, public debt also started declining rapidly towards the end of the 1990s.[76]

The Scandinavian model is hardly a route for prosperity. Even though these nations generally rely on free markets in most sectors, high tax rates and excessive government gradually reduce competitiveness. Scandinavian governments have sought to reduce the burden of government, but the reforms are just a

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74. Chresten Anderson, Dag Ekelberg, Hjortur J. Gudmundsson, Johnny Munkhammar, and Martti Nyberg, "Nordic Stars," *The Wall Street Journal*, March 16, 2006.

75. *Ibid.*

76. Hauptmeier *et al.*, "Expenditure Reform in Industrialized Countries," pp. 20 and 23. Emphasis in original.

small step on a long journey. Other nations would be well advised to avoid the mistakes that Scandinavians are now trying to undo.

The Swedes, at least, seem to understand this lesson. In the September election, voters rejected the incumbent government, giving the Social Democrats their lowest share of the vote since 1914. High unemployment and stagnant living standards were key issues.[77]

77. Daniel J. Mitchell, "Hoping to Restore Growth, Voters Rebel Against Sweden's High-Tax Welfare State," Heritage Foundation *WebMemo* No. 1219, September 21, 2006, at *www.heritage.org/Research/Taxes/wm1219.cfm*.

APPENDIX 2
IS EUROPE CHOOSING LEISURE?

Is it possible that high taxes and spending are not harming Europe and that lower levels of economic output merely represent cumulative voluntary decisions to choose higher levels of leisure? This is not a preposterous assertion. After all, very few people choose to maximize their income, preferring instead to enjoy weekends, vacations, and workweeks of about 40 hours.

However, this does not appear to be the case in Europe. As the president of the European Central Bank recently remarked:

> Lower participation rates are not necessarily solely associated with personal preferences, but are also triggered by the legal and regulatory environment, tax systems and social institutions. Benefit systems that are too generous discourage job search, early retirement schemes encourage early withdrawal from the labour market—employment rates for older workers aged 55–64 stood at just 40.2% in the euro area in 2005 and, according to the OECD, at around 60% in the U.S.—and marginal tax rates that are too high discourage labour market entry and have a downward effect on average hours worked.[78]

An OECD study also threw cold water on the assertion that Europeans have freely chosen to work less:

> [T]he leisure time enjoyed by individuals is obviously important for any evaluation of well-being, and workers' choices on how to allocate their time have a direct bearing on cross-country comparisons of economic aggregates.… [A]s European workers worked more than their US counterparts up to the late 1960s, it is difficult to invoke long-standing cultural differences to explain current labour-utilisation patterns. A different explanation focuses on the role of policies and institutions, which may both depress and boost working hours.… [R]elatively low hours worked per person in Europe can be fully explained by policy distortions arising from high marginal taxes on labour.[79]

The claim that Europeans enjoy more leisure is also a bit of a myth. The workweek is composed not only of hours in paid employment, but also of time spent in household production. A German study explains that Americans enjoy the same leisure as Germans:

> …In principle, households can choose between gainful employment and the purchase of goods and services in the market on the one hand, and self-provision of these goods and services via household production on the other. The choice of products to be purchased in markets and goods to be provided via household production will be influenced by the relative costs of these two alternatives. In general, market provision will be preferred to household production if the productivity differentials between these two modes of provision are high and/or if the differentials between the individual's own wage and the wage of the professional are high and the wedge is small.
>
> …[I]ncome taxes and sales taxes (valued-added tax in Germany) are higher in Germany, creating a bigger tax-wedge there than in the US. For this reason, it may be more attractive for German households to provide certain services themselves ("in-house") rather than to purchase them in the market, whereas it may be better for Americans to purchase services in the market and work longer

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78. Trichet, "Structural Reforms in Europe."

79. Romina Boarini, Åsa Johansson, and Marco Mira D'Ercole, "Alternative Measures of Well-Being," Organisation for Economic Co-operation and Development, Economics Department *Working Paper* No. 476, January 30, 2006, at *www.olis.oecd.org/olis/2006doc.nsf/43bb6130e5e86e5fc12569fa005d004c/407e59fce61acd81c125710d003d6c67/$FILE/JT00200315.PDF* (July 28, 2006).

> hours in gainful employment. In other words, more services should be produced in markets in the US, whereas similar services should be provided in household production in Germany.
>
> According to the division of labor hypothesis, both time spent in gainful employment and time spent in household production should be taken into account when evaluating differences in working hours between the US and Germany. This measure provides a very different picture of hours worked in the two economies.… [O]n average Americans and Germans spend roughly the same hours working, but Americans spend more time in market work while Germans spend more hours in household production. Americans do not work longer hours than Germans overall, but they allocate a larger share of working time to gainful employment and invest less in self-provision.
>
> This analysis of time-use data in the US and in Germany has shown that the opportunity costs of time have a significant influence on the time-allocation for women. A lower wedge and a wider wage dispersion makes market work more attractive and this may actually be the key variable explaining transatlantic differences in time-use. In addition, women are represented a much higher share among the high-wage earners in the US than in Germany, that is that for relatively more women the decision will be made in favor of market work and market provision rather than housework and self-provision in the US.[80]

A study from the Boston Federal Reserve confirms that high income levels enable Americans to enjoy more leisure, even though the time spent in paid employment has not declined:

> [L]eisure time—measured in a variety of ways—has increased significantly in the United States between 1965 and 2003.
>
> [L]eisure has increased by 7.9 hours per week on average for men and by 6.0 hours for women between 1965 and 2003.… [T]he decline in total work (the sum of total market work and total non-market work) was nearly identical for the men and women (7.9 and 7.7 hours per week, respectively). These increases in leisure are extremely large. In 1965, the average man spent 61 hours per week and the average women spent 54 hours per week in total market and non-market work. The increase in weekly leisure we document between 1965 and 2003 represents 11 to 13 percent of the average total work week in 1965.
>
> …Men increased their leisure by allocating less time to the market sector, whereas leisure time for women increased simultaneously with time spent in market labor. This increased leisure for women was made possible by a decline in the time women allocated to home production of roughly 11 hours per week between 1965 and 2003. This more than offset women's 5-hours-per-week increase in market labor.[81]

Individuals should be free to choose the amount of labor or leisure that maximizes their happiness. When tax rates penalize paid employment, they simultaneously reduce hours in the work force and increase time spent in household production, especially since people with less income cannot afford to pay others to provide those services. Europe is not choosing leisure. Instead, high tax rates and an excessive burden of government combine to push workers into suboptimal choices.

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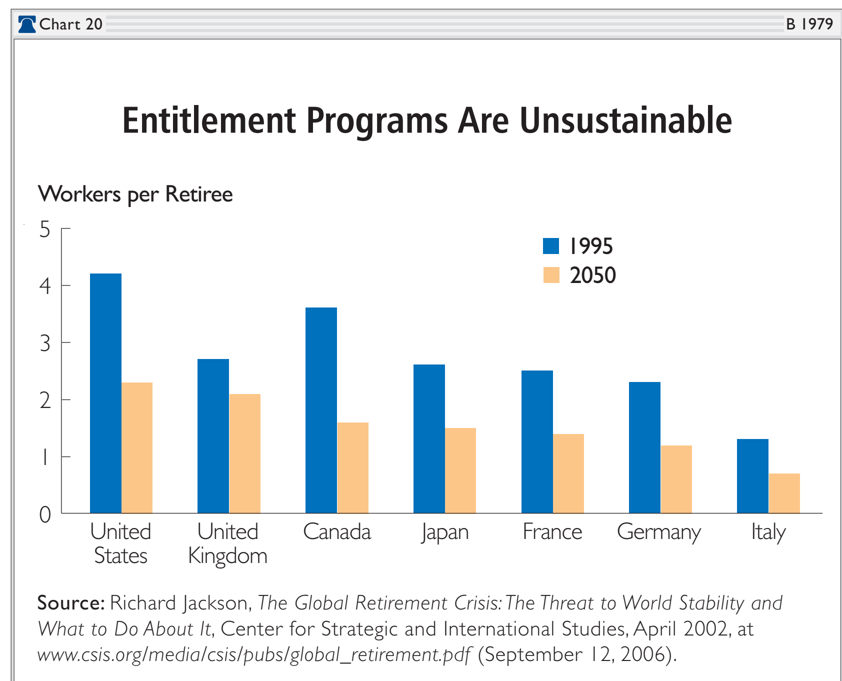
80. Ronald Schettkat, "Differences in US–German Time-Allocation: Why Do Americans Work Longer Hours Than Germans?" Institute for the Study of Labor *Discussion Paper* No. 697, January 2003, pp. 2–3 and 15, at *ftp://repec.iza.org/RePEc/Discussionpaper/dp697.pdf* (July 28, 2006).

81. Mark Aguiar and Erik Hurst, "Measuring Trends in Leisure: The Allocation of Time over Five Decades," Federal Reserve Bank of Boston *Working Paper* No. 06–2, January 2006, pp. 1 and 2–3, at *www.bos.frb.org/economic/wp/wp2006/wp0602.pdf* (July 28, 2006).

APPENDIX 3
A MORE DISMAL FUTURE FOR EUROPE…AND MAYBE FOR AMERICA

Europe is suffering from excessive government. Cross-country comparisons illustrate that both taxes and spending harm economic performance. This should lead policymakers to reduce the burden of government, but there are reasons to think that the problem will get worse before it gets better. Because of demographic changes, it is likely that the public sector will consume even more of Europe's economic output in the future. Without reforms, the United States will suffer the same fate. The following sobering statistics come from a report published by the Center for Strategic and International Studies:

- Life expectancy has increased more in the past 50 years than it did in the previous 5,000 years.
- The share of the population in the developed world over age 65 will jump from 16 percent today to 27 percent in 2050—over 35 percent in Italy.
- The number of beneficiaries is growing 14 times faster than the number of workers in the developed world.
- By 2050, most G-7 nations will have fewer than two workers per retiree. (See Chart 20.)
- Europe's work force will decline by 9 percent by 2030.
- Social insurance taxes already consume 30 percent of wages in Europe—40 percent in Germany, France, and Italy.
- To fulfill existing commitments, spending on government pensions will need to rise by 4.4 percent of GDP by 2050—7.0 percent according to private projections.
- Government health care spending for the elderly will add another 2.5 percent of GDP to the burden—5.5 percent according to private estimates. Other health care outlays worsen the outlook.[82]



Source: Richard Jackson, *The Global Retirement Crisis: The Threat to World Stability and What to Do About It*, Center for Strategic and International Studies, April 2002, at *www.csis.org/media/csis/pubs/global_retirement.pdf* (September 12, 2006).

Other institutions have reached similar conclusions. The OECD projects that government retirement benefits will exceed 16 percent of GDP in Germany, France, and Italy by 2030. Unfunded pension liabilities in Germany already exceed 100 percent of GDP. Bad as that is, France and Italy are in worse shape with unfunded pension liabilities exceeding 200 percent of GDP. In most EU countries, the implicit debt of unfunded pension programs is two or three times greater than the explicit national debt.[83]

82. Richard Jackson, "The Global Retirement Crisis: The Threat to World Stability and What to Do About It," Center for Strategic and International Studies, April 2002, at *www.csis.org/media/csis/pubs/global_retirement.pdf* (July 28, 2006).

83. William Shipman, "Retirement Finance Reform Issues Facing the European Union," Cato Institute *Social Security Paper* No. 28, January 2, 2003, at *www.socialsecurity.org/pubs/ssps/ssp28.pdf* (July 28, 2006).

The European Commission's Kok Report estimates that the "age-dependency ratio" in the European Union will climb from 26 percent to 49 percent, which means that there will be two working-age people for every old person rather than four working-age people for every old person. "[T]he average ratio of persons in retirement compared with those of the present working age in Europe will double from 24% today to almost 50% in 2050."[84] In addition:

> [T]he pure impact of ageing populations will be to reduce the potential growth rate of the EU from the present rate of 2–2.25% to around 1.25% by 2040. The cumulative impact of such a decline would be a GDP per head some 20% lower than could otherwise be expected. Already from 2015, potential economic growth will fall to around 1.5% if the present use of the labour potential remains unchanged. This same ageing will result in an increase in pension and health-care spending by 2050, varying between 4 and 8% of GDP.[85]

These estimates, moreover, may be too optimistic. The Kok Report assumes that the total employment rate in Europe will jump from 63 percent to 70 percent. Even less plausibly, it also assumes that the employment rate of older workers will jump from 40 percent to 59 percent. In addition, it predicts that potential growth between 2031 and 2050 will be 1.3 percent yearly, although this may be too optimistic. Likewise, the prediction that government spending will climb by only 4 percentage points of GDP may be too sanguine. As another study prepared by the European Commission acknowledged:

> Europe's population will be slightly smaller, and significantly older, in 2050. Fertility rates in all countries are projected to remain well below the natural replacement rate. Life expectancy at birth, having risen by some 8 years since 1960, is projected to rise by a further 6 years in the next five decades.… Starting already from 2010, the working-age population (15 to 64) is projected to fall by 48 million (or 16%) by 2050. In contrast, the elderly population aged 65+ will rise sharply, by 58 million (or 77%) by 2050. The old-age dependency ratio, that is the number of people aged 65 years and above relative to those between 15 and 64, is projected to double, reaching 51% in 2050. Europe will go from having four people of working age for every elderly citizen currently to a ratio of two to one by 2050.[86]

The same report also admits that:

> Overall, ageing populations is projected to lead to increases in public spending in most Member States by 2050 on the basis of current policies.… [F]or the EU15 and the Euro area as a whole, public spending is projected to increase by about 4 percentage points between 2004 and 2050.… [M]ost of the projected increase in public spending will be on pensions, health care and long-term care. Potential offsetting savings in terms of public spending on education and unemployment benefits are likely to be limited.… [T]he largest increases in spending are projected to take place between 2020 and 2040.[87]

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84. European Commission, "Facing the Challenge," p. 13.

85. *Ibid.*

86. European Commission, Economic Policy Committee and Directorate General for Economic and Financial Affairs, *The Impact of Ageing on Public Expenditure: Projections for the EU25 Member States on Pensions, Health Care, Long-Term Care, Education and Unemployment Transfers (2004–2050)*, Directorate General for Economic and Financial Affairs *European Economy Special Report* No. 1/2006, p. 7, at *http://ec.europa.eu/economy_finance/publications/european_economy/2006/eesp106en.pdf* (September 29, 2006).

87. *Ibid.*, p. 10.