THE PATH TO SUSTAINABLE GROWTH

LESSONS FROM 20 YEARS GROWTH DIFFERENTIALS IN EUROPE

PART 1 - THE ECONOMICS OF TAXATION

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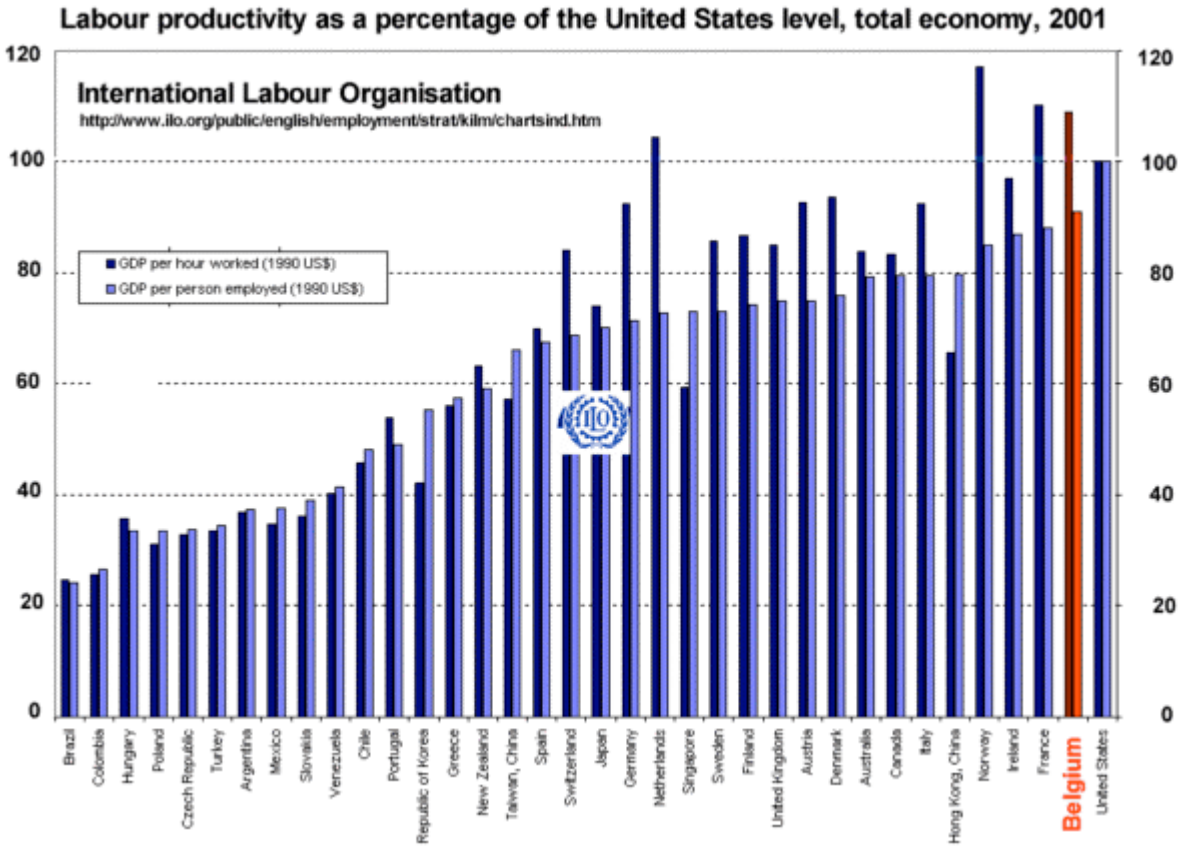
Introduction: European Growth Performances differ most widely.

The main purpose of this study is to search for the causes of growth differentials within Europe. We have special interest in finding the reasons behind Europe's weak socio-economic performances as compared to the rest of the world, and particularly of countries like France, Germany, Belgium, Italy, etc. In economic and political analysis slow growth is often attributed to external factors such as cyclical fluctuations or high oil prices. Considering other countries like Ireland and Luxembourg are performing remarkably well under the same external conditions, external factors can at the most be part of the problem. Empirical research has also extensively examined micro-economic differences between businesses and behavioural differences between citizens for explaining growth differentials.

Productivity and labour ethics not necessarily translated into wealth

However also these micro-economic differences give a very limited explanation. France and Belgium for instance belong to the world top as to productivity, education level, and particularly the creativity and commercial spirit of their entrepreneurs have made Belgium the greatest per capita exporter. This excellent potential, which in many aspects is better than Ireland's or Luxembourg's, is however not translated neither in a similar growth rate, nor in welfare for the population.

The causes of France's and Belgium's weak performance are clearly not the failure of industry and agriculture, and cannot be attributed to lack of managerial organisation, nor to lack of work zest of the employees. The graphic of the "International Labour Organisation" illustrates that for instance french and Belgian productivity per working hour is the highest in the world after Norway.[1] Belgian productivity per employee is even ranked second in the world (after the USA). French and Belgian productivity however far higher than the Irish, does not translate into higher wealth for the population. Obviously growth differentials cannot be explained by this key factor productivity one would reasonably expect. Fundamental causes are more likely to be found in macro-economic public policy. In this study we have therefore special attention for macro-economic strategy, and taxation policies in particular.

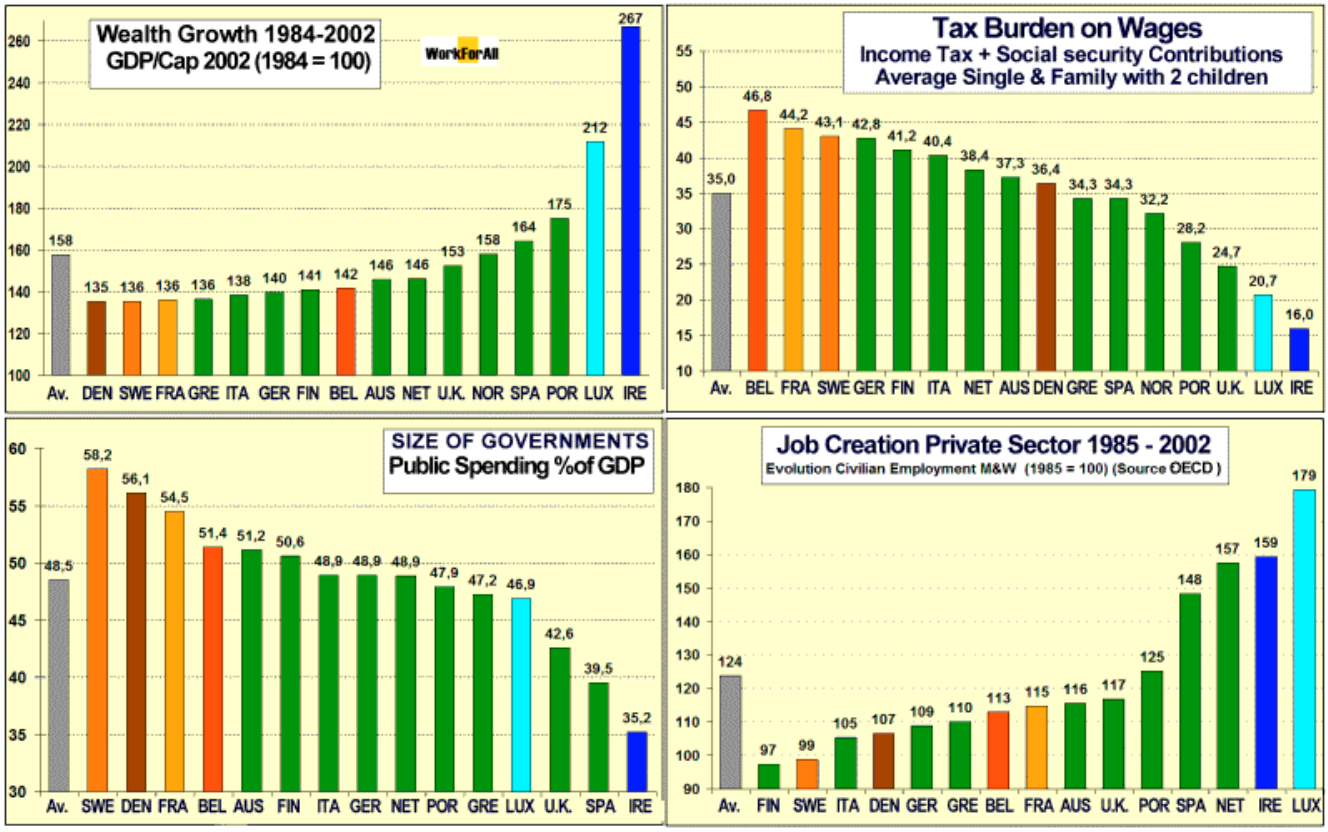


1 Norway however thanks its high productivity to its large oil extracting industry. Source: International Labour Organisation. http://www.ilo.org/public/english/employment/strat/kilm/trends.htm

Quick look at the facts:

Most European governments control around 50 % of all outlays, and laws, decrees or other restrictions strictly regulate the other half. Europe's public sector being so large, obviously public policy must have a predominant effect on the economic performances.

A quick look at Europe's performances seems to confirm that big government coincides with poor growth. This negative correlation has been widely described in Anglo-Saxon economic literature. However this aspect is seldom mentioned and often denied by continental European literature. The graphs also seem to confirm the intuition that excess labour taxation has a strong negative effect on job creation.



Big Government and Taxation Structures:

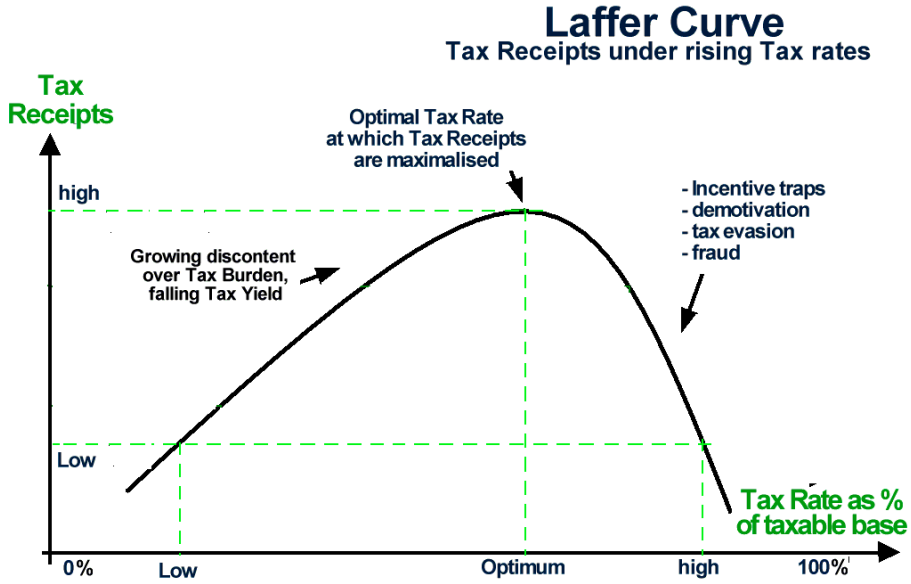
Ireland is by far Europe's best performing country both as to wealth growth and to the number of new jobs created. Its economic and fiscal policies are at least worth examining and considering for other' countries. Ireland is characterised by moderate public spending as compared to other countries, and by a flat tax structure.

As economic theory suggests, high taxes on income tend to discourage risk taking, investment, effort and growth. High taxes on labour and income make labour expensive and encourage automation at the expense of job creation, while high taxes on saving discourage investment. A heavy tax burden on the domestic production factors labour and capital and a relatively low tax on consumption, factually subsidise the import of goods from abroad. Direct taxation is therefore considered as the most distorting form of taxation, having the exact opposite effect of protectionism. The coincidence of Ireland's unique taxation policy and its excellent performances seems at first glance to confirm the intuition of the importance of taxation policies. In Part I we therefore look at recent developments in the economics of taxation.

Part 1 - The Economics of Taxation

Laffer: maximising Tax Receipts.

Laffer analyses the evolution of tax receipts when the tax burden increases. Starting from a hypothetical situation where the tax rate is zero, tax receipts are of course also zero. In the opposite case, when tax rates are raised to 100% (or more) tax receipts will also decrease to zero, as tax payers have no more interest in working and broadening the taxable base (work, profit). In such case, they do everything in their power to escape total confiscation, either through different sorts of evasion mechanisms and fraud either by stopping to work altogether.



Gradually raising taxes from zero initially will result in an increase of the tax receipts that are proportional with the tax rate hike. Yet further increase of tax rates results in tax receipts starting to lag behind, as resistance against the tax burden gradually grows. Taxpayer gradually perceives rising taxes as unreasonable, and gradually mechanisms of tax evasion (working less) or even tax fraud become popular. Beyond the critical optimal tax rate, tax receipts even decline as the tax rate rises further.

Illegal tax fraud is only a minimal part in the evasion mechanisms. Fully legal evasion due to de-motivation is of much larger importance. Such evasion mechanisms are found in every aspect of daily life and in all classes of the population. Excessive income tax rates will cause workers and entrepreneurs alike to avoid overtime. Or one of the spouses will tend to limit his productive contribution to the economy to a part-time job.

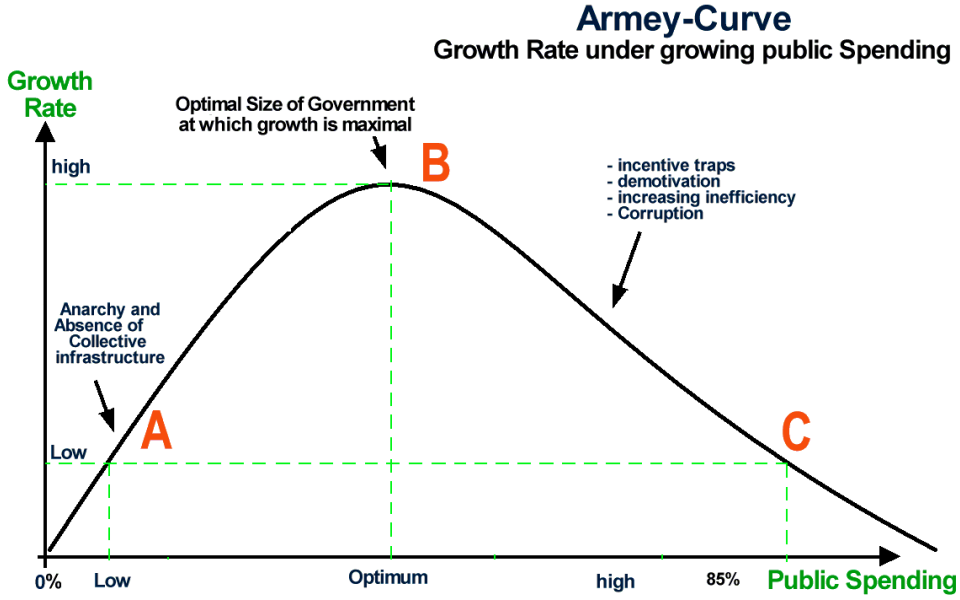
In addition, most peculiar and even funny evasion mechanisms are set in motion. Surgeons starting to paint their homes for instance. Not because they are so eager to do such a painting job, but simply because an additional hour operating yields them less than the gross wage they would pay a professional painter to do it. On the micro-economic level these surgeons make the right decision as a good fathers of the family. On the Macro-economic level (considering the effect on the total GDP output), his choice is of course pure waste. Surgeons valorise their expensive training much more effectively operating than painting, and they presumably would find much more satisfaction in it. Excessive taxes simply tend to erase the advantages of specialisation, the basic principle of every trading economy.

The evasion mechanisms cannot be blamed on bad intentions. They are the individual's expression of a natural desire to optimise the yield of their individual effort and capital under given circumstances, weighing marginal benefits against marginal efforts and risks. This is inherent in every society regardless political or economical structures.

Remains the question at what level do we find the optimal tax rate at which tax receipts are maximised? This depends on the kind of tax, the difficulty of tax evasion, the risk connected to fraud, and not in the least the citizens' feelings about the good usage of public funds by the authorities. In countries where the citizens appreciate that public money is well spent for the benefit of all, citizens will rather gladly contribute their equitable share in the public spending. In countries where governments are corrupt, inefficient, wasting public money, or give inequitable advantages to particular groups, evasion mechanisms start at an earlier point, and the optimal tax rate at which tax receipts are maximal, will tend to be lower. The Laffer optimum at which authorities maximise tax receipts in the short run is believed to be situated at the marginal rate of between 40% and 50%. Rates above the Laffer optimum will be perceived by the taxpayer as unreasonable and evasion mechanisms will cause tax receipts to drop rapidly through less work, less investments and less economic activity.

Armey: Optimising Growth Prospects.

Laffer analyses the question of maximising tax receipts. However the optimal tax rate at which tax receipts are optimised does not coincide with the tax level at which other social objectives such as maximal wealth creation and new job creation are optimised.



Barro (1990) was concerned about finding the optimal tax burden and government spending level at which wealth creation is maximised. This aspect was popularised in 1995 by Richard Keith "Dick" Armey (°1940), when he proposed his Armey curve. Armey argues that non-existence of government causes a state of anarchy and low levels of wealth creation, because of the absence of the rule of law and protection of property rights. In civilisations with extremely small or non-existing public sectors, citizens lack the incentives to save and invest. The absence of the rule of law and continuous threat of theft or expropriation has demotivating effects. Also the total lack of collective infrastructure leads to poor productivity and consequently low levels of wealth creation.

Similarly, when all input and output decisions are in the hands of the authorities, wealth creation is also very low. As Laffer argued before, citizens then also have very little incentive to productive contribution, considering the authorities confiscate the total yield of their efforts. However, wherever there is a mix of private and government initiative on the allocation of resources, output will tend to grow. Initially as the public sector builds up, the wealth creation will gradually grow larger. A state off law and order is being installed, collective infrastructure such as roads, bridges and means of communication are being built, all contributing to increased productivity. Also the installation of education structures and social programs destined at preventing the exclusion of disabled boost wealth creation. This evolution is projected as the part of the curve between Points A and Point B. In the early stages of development, the productivity of well conceived collective spending is mostly higher than the average productivity of private spending. Therefore, such public spending will lead to higher wealth creation.

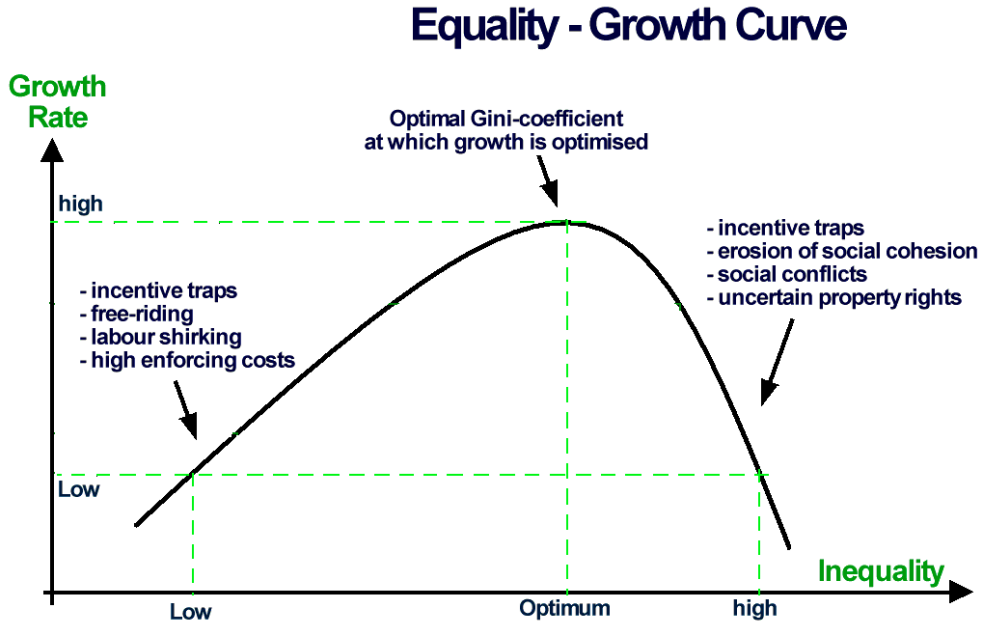
Nevertheless, additional public projects increasingly lose their productivity advantage over private investment, whilst the heavier tax burden needed for financing government increasingly demotivate citizens to productive contribution. Social programs also loose their growth effect when they tend to provide incentives to leave the productive sector rather than preventing exclusion.

Growth-enhancing features of government spending gradually diminish and further expansion of government spending beyond the Army-optimal point B, does no longer lead to output expansion. At that point, the marginal productivity of public spending equals the marginal productivity of private spending, and the benefits from increased government spending become zero. Beyond this optimal point B additional government spending lead to ever lower wealth creation, as ever more scarce resources are withdrawn from the private sector, where they could have been used more productively. (Evolution from Point B to Point C.). The shape of the Armey-curve therefore has a similar shape as the Laffer curve, the optimum however being at a substantially lower taxation level than the Laffer optimum.

Optimising Distribution of Wealth

Nobelprize winner Kuznets (1971) found empirical evidence that also inequality historically follows a similar inverted U-shape curve. The 'Kuznets hypothesis'[2] suggests that in the early stages of economic development, when investment in physical capital is the main mechanism of economic growth, inequality encourages growth by allocating resources towards those who save and invest. The opposite happens in mature economies, when human capital accrual takes the place of capital accrual as the main engine of growth.

In their study for the World Institute for Development Economics Research,[3] Giovanni Andrea Cornia and Julius Court (2001) reach analoguous conclusions. The authors therefor recommend to pursue moderation also as to the distribution of wealth and particularly to avoid the extremes. Both very high egalitarianism and very high inequality cause slow growth. Extreme egalitarianism leads to incentive-traps, free-riding, high operation costs and corruption in the redistribution system, all reducing a country's growth potential. However also extreme inequality diminishes growth potential through the erosion of social cohesion, increasing social unrest and social conflict causing uncertainty of property rights. Therefore public policy should target an 'efficient inequality range'. The authors claim that such efficiency range roughly lies between the values of the Gini coefficients of 25 (the inequality value of a typical Northern European country) and 40 (that of countries such as China and the USA). The precise shape of the inequality-growth relationship depicted in the Chart obviously varies across countries depending upon their resource endowment, history, remaining levels of absolute poverty and available stock of social programs, as well as on the distribution of physical and human capital.



Empirical Evidence

The three theories described above suggest that the relationships between growth potential on the one side, and tax burden, tax receipts, size of government and redistribution on the other side are non-linear relationships and that consequently interrelated optimal levels of taxation, size of government and redistribution exist. As to the relation between income inequality and rates of growth Robert J. Barro gave evidence (1999) from a broad panel of countries that inequality retards growth in poor countries but encourages growth in richer places.

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[2] http://en.wikipedia.org/wiki/Kuznets_curve

[3] Inequality, Growth and Poverty in the Era of Liberalization and Globalization. UNU World Institute for Development Economics Research (UNU/WIDER) http://www.wider.unu.edu/publications/pb4.pdf

Growth tends to fall with greater inequality when per capita GDP is below around $2000 (1985 U.S. dollars) and to rise with inequality when per capita GDP is above $2000. The results mean that income-equalising policies might be justified on growth promotion grounds in poor countries. For richer countries, active income redistribution appears to involve a trade-off between the benefits of greater equality and a reduction in overall economic growth. [4] Many governments have had the experience of beneficial and generally larger than expected Laffer-effects when they lowered tax rates. A typical case was when the Flemish authorities decided to lower estate-duties and gift taxes. Although Belgians were not dying earlier than before, and estates had not remarkably grown, tax receipts immediately started to rise spectacularly. Belgians obviously since long had perceived the estate tax rates as excessive and highly unfair. The tax burden on estates obviously had been well beyond the optimal Laffer optimum. The new tax rates now clearly were found acceptable. Tax evasion and fraud diminished, resulting in good business for both the tax authorities as well as for the peace of mind of taxpayers and ultimately for the wealth of the country.

The Importance of choosing the right Policy Mix.

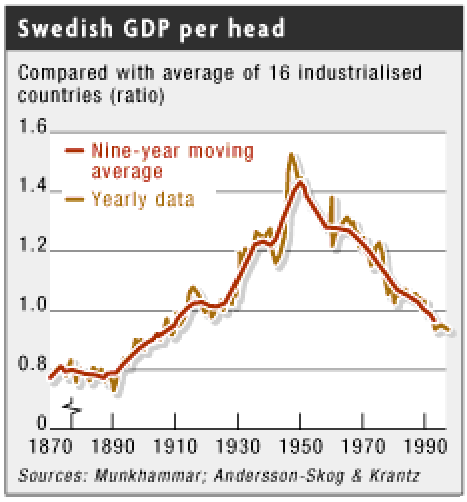
The adverse long-term effects of excessive public spending and excessive redistribution in highly developed countries can be illustrated by comparing economic performances comparable economies however with very different policy mixes: Sweden and Ireland. In their effort to reduce poverty and create an equitable society, Swedish authorities have developed considerable redistribution structures with levels of public spending being by far the highest in the OECD. As a result of these efforts the poorest 20% Swedes earn 9,1% of total income as compared to 7,1% only of total income earned by Ireland's 20% poorest.[5]

However the price to pay was a heavy Swedish tax burden needed for financing the system, averaging 50.62% form 1985 to 2003 as compared to 33.41% only in Ireland. The consequence of the heavy Swedish tax burden was lower incentives to constructive contribution, ultimately resulting in Swedish GDP growth stagnating at 2.02% on average over the last 20 years (volume indices). This compares to the fabulous Irish growth rate of 5,78%. On the basis of these ***very real historical performance figures*** the table below simulates the evolutions of GDP, tax receipts, disposable income as well as real income of 20% poorest earners over 20 years of sustained Swedish and Irish policies.

	Swedish Policy mix				Irish Policy mix			
	GDP Growth	Tax receipts	Disposable Income	Income 20% poorest	GDP Growth	Tax Receipts	Disposable Income	Income 20% poorest
Rate	2,02%	50,6%	49,4%	9,1%	5,78%	33,4%	66,6%	7,1%
Year	100,0	50,6	49,4	9,1	100,0	33,4	66,6	7,1
1	102,0	51,6	50,4	9,3	105,8	35,3	70,4	7,5
2	104,1	52,7	51,4	9,5	111,9	37,4	74,5	7,9
3	106,2	53,7	52,4	9,7	118,4	39,5	78,8	8,4
4	108,3	54,8	53,5	9,9	125,2	41,8	83,4	8,9
5	110,5	55,9	54,6	10,1	132,4	44,2	88,2	9,4
6	112,7	57,1	55,7	10,3	140,1	46,8	93,3	9,9
7	115,0	58,2	56,8	10,5	148,2	49,5	98,7	10,5
8	117,3	59,4	57,9	10,7	156,8	52,4	104,4	11,1
9	119,7	60,6	59,1	10,9	165,8	55,4	110,4	11,8
10	122,1	61,8	60,3	11,1	175,4	58,6	116,8	12,5
11	124,6	63,1	61,5	11,3	185,5	62,0	123,6	13,2
12	127,1	64,3	62,8	11,6	196,3	65,6	130,7	13,9
13	129,7	65,6	64,0	11,8	207,6	69,4	138,2	14,7
14	132,3	67,0	65,3	12,0	219,6	73,4	146,2	15,6
15	135,0	68,3	66,7	12,3	232,3	77,6	154,7	16,5
16	137,7	69,7	68,0	12,5	245,7	82,1	163,6	17,4
17	140,5	71,1	69,4	12,8	259,9	86,8	173,1	18,5
18	143,3	72,6	70,8	13,0	275,0	91,9	183,1	19,5
19	146,2	74,0	72,2	13,3	290,8	97,2	193,7	20,7
20	149,2	75,5	73,7	13,6	307,7	102,8	204,9	21,8
	GDP Growth	Tax receipts	Disposable Income	Income 20% poorest	GDP Growth	Tax Receipts	Disposable Income	Income 20% poorest

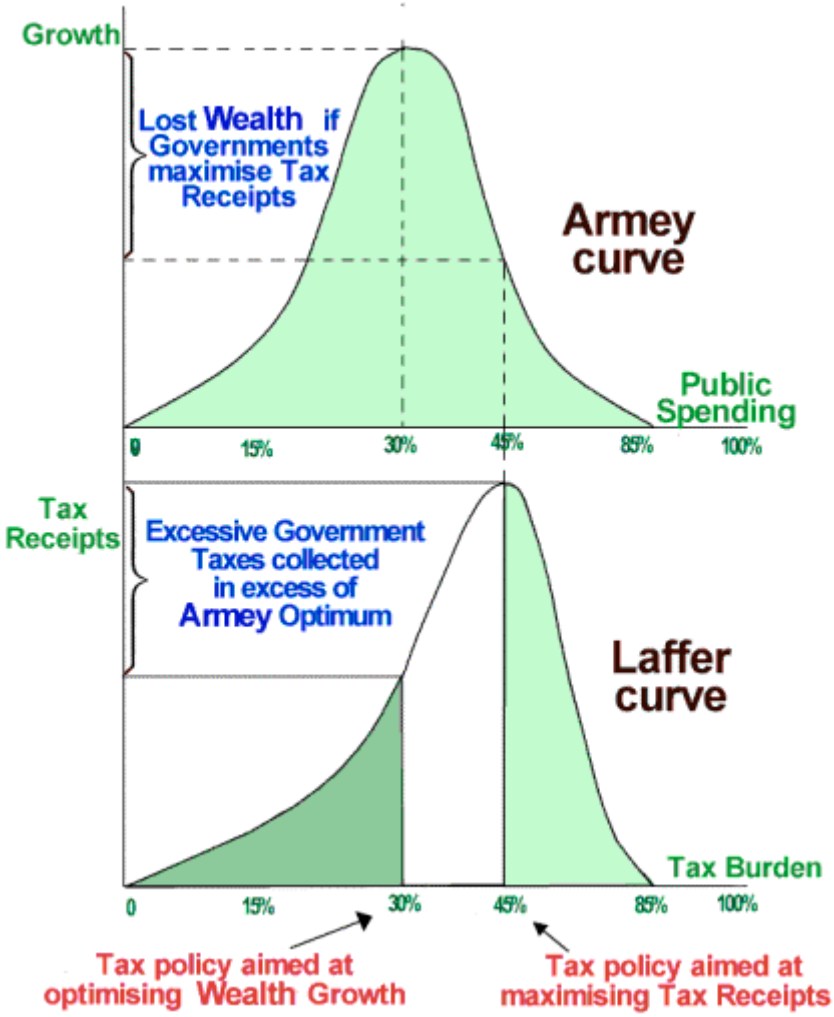
[4] Inequality and Growth in a Panel of Countries*, Robert J. Barro, Harvard University, 1999
http://post.economics.harvard.edu/faculty/barro/papers/p_inequalitygrw.pdf

[5] http://hdr.undp.org/statistics/data/excel/hdr05_table_15.xls



The difference in socio-economic performance between both policies is tremendous. The prosperity (GDP/Cap) of a country adopting 20 years of sustained Irish policies, is more than twice as high as a country adopting Swedish policies, and disposable income for the citizens is even almost 3 times as high. But most remarkably also the poor are much better off under the Irish policy. Although Swedish policies were designed to reduce poverty, and although the Irish poor start with an income handicap of some 20% as compared to their Swedish colleagues, after 6 years only of fast growth under Irish-type policies, the Irish poor already reached the level of wealth of the Swedish poor. After 15 years the Irish poor are some 50% better off in real terms than the Swedes and the Irish poor will be substantially better of than the Swedes forever after. Well-meant but shortsighted egalitarianism, often inspired by the absurd relative definition of poverty ultimately decreases the long-term prosperity prospects of the poor in real terms.

Remarkably in the long run also the taxman is better off with a moderate tax burden. Although Irish tax receipts at the start are some 40% lower than the Swedish, after 11 years only Irish tax receipts in real terms equal Swedish and will be higher for ever after. However the greatest benefits of Irish policies lies in the evolution of net disposable income for the citizens. After 20 years of sustained Irish policies disposable income for the average Irish is nearly 3 times higher than under sustained Swedish policies. The table illustrates how excessive government spending and well-meant egalitarianism through mechanisms such as de-motivation, high cots of enforcing and complying with the tax system and tax evasion is trading off future prosperity (particularly for the poorest) against short-term equality.



The long-term interest of both the wealthy and the poor lies in growth enhancing policies such as under the Irish model, rather than demotivating egalitarian policies such as Sweden. In the long run governments will also maximise their tax receipts and public policy margin when choosing such policies. Hence in the long run tax receipts are not maximised at the short term Laffer Optimum, but at the Armey optimum at which growth is maximised, and which is situated at much lower levels of taxation.

The final outcome in Table above illustrates the overwhelming importance of choosing the right policy mix. With the challenges facing Europe; both globalisation and the demographic time bomb Europe cannot afford to choose the wrong way. Only pro-growth policies can provide the resources for sustainable financing both Europe's generous social security system and the costs of ageing.

Unfortunately well meant but short term thinking still prevails in many European countries. In their efforts to create a more equitable society most European social models continue to simultaneously combine high average taxation, with strongly progressive tax structure, and regressive social benefits. The combined application of these three "social" policies often lead to excessive egalitarianism, resulting even often in negative net compensation of the constructive contribution to society. Eventually ever more workers and entrepreneurs do realise that their efforts are no longer beneficial under the prevailing social system, and eventually scale back their constructive contribution.

Excessive egalitarianism is most often inspired by the relative definition of poverty. This misleading relative definition of poverty has institutionalised envy rather than freedom from want or absolute progress as the key motive in the social models. The ultimate consequences of such policies are disastrous for growth and ultimately for the sustainability of every social model. The core functions of government are vitally important. Governments are indispensable for functions like the protection of the state of law, to enforce property rights and contracts, and to initiate investment in basic infrastructure. However, as authorities move too much beyond their core functions, the tax and spending policies of governments soon become counterproductive and they begin to restrain economic growth and cause income levels to fall well below their potential. This is precisely what has happened in the European countries in recent decades.

Europe's Empirical Armey Optimum

In previous chapter we have realised the overwhelming importance of choosing the right policies. We found evidence that it is in the long run interest of both the wealthy and the poor, for both disposable income and tax receipts that governments choose a policy mix which maximises growth rather than maximises short-term tax receipts and optimises equality in the short run.

Remains the question at what level do we find this optimal size of government at which growth prospects are and consequently also tax receipts in the long run are optimised. Beyond which point does additional redistribution of income and wealth harm progress? It is generally believed that the optimum varies across countries depending upon the state of development, the amount of social and economic infrastructure already available, cultural differences, the intensity to the social network, and not in the least attitude towards government.

The optimal size of American public spending at which growth prospects are optimised has been calculated in numerous American empirical studies on basis of historical data. The Researchers Vedder and Gallaway (1998) found the optimal US public spending rate for the period 1947-1997 to be situated around 17,45% of the GNP. Pens (1991) estimate it at 20%. For Canada, the optimal size was calculated to be situated around 27%.

In Europe, the question of optimal size of government has long remained taboo. Although the economic impact of this question is overwhelming, this domain of investigation remained unexplored for over 15 years in European universities. Europe had to wait for Primoz Pevcin, Ph. D. of the University or Ljubljana to first estimate the optimal size of public spending for the European countries. On basis of historical data from 1950 to 1996 Primoz[6] calculates the average optimal size of government for 12 European countries, including Belgium, France, Sweden at between 36.6 and 42,12% of GNP. Primoz further confirms that this optimum is reached at different levels in each country according to their social and economical structure. He calculated the empirical optimal size for eight European countries at which their potential is optimised as follows:

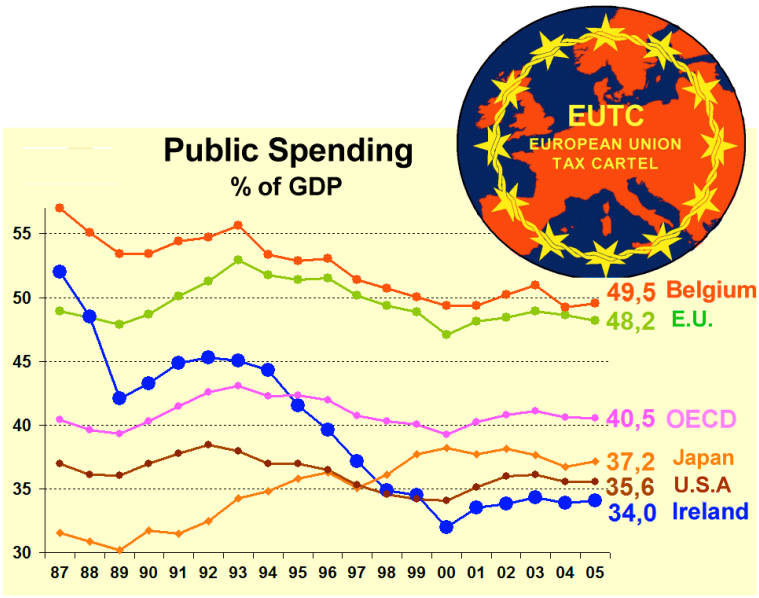
Country	Actual Size of Government (Public Spending % of GNP 1996)	Armey-Curve Optimum (Optimal level of public spending)	% Oversize
Italy	44.90	37.09	17.39
France	54.73	42.90	21.62
Finland	58.74	38.98	33.64
Sweden	65.02	45.96	29.31
Germany	48.72	38.45	21.08
Ireland	39.60	42.28	- 6.77
Netherlands	51.97	44.86	13.68
Belgium	52.97	41.91	20.88
Average			18.85

Source: PRIMOž PEVCIN (2004) University of Ljubljana, Does optimal size of government spending exist?

[6] http://www.soc.kuleuven.ac.be/pol/io/egpa/fin/paper/slov2004/pevcin.pdf

Under-performance: logical Consequence of an oversized Public Sector.

The oversize of European governments is exceptional both historically and as compared to the rest of the world. Less than fifty years ago developed countries flourished well with governments spending less than 30% of GDP. Despite the fact one can reasonably expect that progress increases the self-reliance capacity of the citizen, countries of the EU today spend nearly 50% of GDP on average. (See table below).



Having to operate with the demotivating handicap of an oversized parasitical sector, European economies have been under performing heavily compared to the rest of the world. Today's Europe's socio-economic crisis is indeed unfolding while the rest of the world is booming at its fastest rate in three decades. 2004 and 2005 were years for the record books. China and India have double-digit growth rates, and the USA fully enjoys the benefits of globalisation. While the world's economy is booming at an average rate of over 4%, but Europe's growth is stagnating at an inflated 1.5%.

Europe's gradual decline in competitiveness and growth coincided with the gradual growth of Europe's public sector to 50% of GDP and over, reaching a level where public spending was one third higher than OCDE average and its major competitors such as USA and Japan.

Size of Governments in Selected Countries: 1870-1998
Public Spending as a % of GNP[7]

	1870	1913	1920	1937	1960	1980	1990	1998
Australia	18,3	16,5	19,3	14,8	21,2	31,6	34,7	32,9
Austria	10,5	17	14,7	20,6	35,7	48,1	48,6	51,7*
Belgium	-	13,8	22,1	21,8	30,3	58,6	54,8	49,4
Canada	-	-	13,3	18,6	28,6	38,8	46	44,7*
France	12,6	17	27,6	29	34,6	46,1	49,8	54,3
Germany	10	14,8	25	34,1	32,4	47,9	45,1	46,9
Italy	13,7	17,1	30,1	31,1	30,1	42,1	53,2	49,1
Ireland	-	-	18,8	25,5	28	48,9	41,2	37,6*
Japan	8,8	8,3	14,8	25,4	17,5	32	31,7	36,9
N.Zealand	-	-	24,6	25,3	26,9	38,1	41,3	47,1*
Netherlands	9,1	9	13,5	19	33,7	55,2	54	47,2
Norway	5,9	9,3	16	11,8	29,9	37,5	53,8	46,9
Spain	-	11	8,3	13,2	18,8	32,2	42	43,3*
Sweden	5,7	10,4	10,9	16,5	31	60,1	59,1	58,5
Switzerland	16,5	14	17	24,1	17,2	32,8	33,5	37,6*
U.K.	9,4	12,7	26,2	30	32,2	43	39,9	40,2
U.S.A.	7,3	7,5	12,1	19,7	27	31,8	33,3	32,8
Average	10,8	13,1	19,4	23,4	28,1	41,2	43,9	44,3

Source: WILLIAMS DE BROË (2002), Is High Public Spending Good or Bad for You?

[7] Sources: Tanzi and Schuknecht (2000), Table 1.1, pages 6 & 7. International Monetary Fund (IMF), World Economic Outlook, May 2000 (see especially IMF Table 5.4, page 172). http://www.cf.ac.uk/carbs/econ/matthewsk/PubSpendFinal.pdf

Europe's difficult Choice between Social Models

The disappointment with Europe's under-performance, and the feeble outcome of great European projects such as enlargement, integration, the common currency and the Lisbon agenda is tremendous. The expectations from these great projects have not materialised. In stead slow growth has been Europe's share.

Europeans feel that the handicap of oversized government and slow growth will make it extremely difficult to meet the challenges of globalisation, and the fast ageing population. Europeans are loosing patience. In France and Holland this has culminated in a strong NO-vote against the European constitution. In doing so Europeans have strongly condemned the current state of affairs and have called a halt to European bureaucracy and further integration.

Still the political message has not been understood. Nor has the economic lesson from the collapse of the soviet model that markets rather than central planning are the better way to achieve progress, prosperity and happiness. Many still believe Europe's poor performance must be remedied by even more government action, that new and better plans are needed to save Europe from its existential crisis. The only question is how these new plans must look like; what direction Europe should take after the no-vote.

A central issue in this debate is one over the choice of social models. It is the familiar debate between right and left, between liberalism and socialism, between progress and standstill. In this debate we find on the one side of the political spectrum the Scandinavian social model which stands for big government, central planning and egalitarianism. A model in which authorities regulate, tax or subsidise most every aspect of daily life. On the other side of the political spectrum the American laissez-faire liberalism and its moderate European form typically found in Great Britain and Ireland generally called the Anglo-Saxon model.

Nowadays both the Scandinavian and Anglo-Saxon models have moderated from their extreme forms. Today British policies under labour are rather moderate and have only little to do with Tacherian teachings. However particularly Scandinavians have learnt that their social system was leading to disaster, and have since the near collapse of their economies in the early nineties seriously scaled back their strangling hold on the economy.

This has resulted in a reduced but still heavy tax burden and government spending in Scandinavia. However despite moderation on both sides, very substantial policy and structural differences subsist between both social models subsist as the table below clarifies.

Obviously Size of Government does matter.

The obvious central characteristics of the Scandinavian model is the huge size of its public sector and its poor economic performance, characterised by slow growth, and low rates of new jobs creation. Over the last 20 years Scandinavian governments spent on average 56.9% of GDP. Danish governments spent 56.6%, Finish 52.1% and Swedish no less than 62.14% on average from 1985 to 2004. No wonder that the Scandinavian economy came close to standstill in the early nineties and on average booked the slowest growth of Europe over the last 20 years.

The slow Scandinavian growth is remarkable, as Scandinavians work hard. Not only do they have the highest education levels in Europe, they also have the longest working hours. Scandinavians work on average 767 hours per inhabitant per year, as opposed to only 695 hours continental Europe and 706 hours in the UK and Ireland. This is due to Scandinavians having the highest participation rate in Europe. Following the threat of collapse in the early nineties Scandinavians introduced non-indulgent retirement rules as well as limitations of unemployment benefits, resulting in later retirement and higher participation rates particularly through increased rates of two wage earners per family. Ultimately it has resulted in the highest participation in Europe (48,4%) as opposed to 42,6% only on the European continent and 40,9% only in Ireland and the UK. However more sick-leaves and absenteeism has been the price to pay, as well poor motivation on the work floor and consequently poor productivity per hour worked. Altogether working hours per employed person are significantly lower in Scandinavia (1590 hours only vs. 1644 in continental Europe).

Key Characteristics of Western Social Models				
	Scandinavian Model	Continental Europ. Model	Anglosaxon Model	US Social Model
Socio-Economic Performance	Averages of : Swe Fin Den	Aus Bel Fra Ger Gre Ita Lux Net Por Spa	Average of Ireland and UK	USA
Yearly GDP Growth Rate Average % 1985-2004 (volume indices)	1,996	2,635	4,163	2,927
Yearly new JOBS Growth Rate Average % 1990-2004	0,84	1,30	2,68	1,17
Productivity Growth/Hour Worked % progress from 1985 to 2005 (GK$)	152,6	144,4	183,6	142,4
Relative Wealth level 1985 OECD = 100 current prices and current PPPs	113,83	97,45	82,80	139,29
Relative Wealth level 2004 OECD = 100 current prices and current PPPs	108,77	108,20	117,58	139,09
Engaged resources				
Size of Government Government spending % of GDP 1985-2004	56,9	48,0	41,5	35,9
General government total tax and non-tax receipts (% Per cent of GDP)	56,9	44,3	39,4	31,7
Employment to population ratio % 1985-2004	48,4	42,6	40,9	47,13
Annual Hours Worked/Employed Groningen Development Centre	1590	1644	1741	1846
Participation Hours/Annual hours worked per person employed x employment/pop rate	767	695	706	870
Dicect Taxes % of total taxation Tax on income, profits, Social sec. contributions	65,4	63,5	54,3	53,6
Taxes on goods and services As a % of total taxation 1985-2004	29,9	30,1	36,6	18,5
Gross domestic expenditure on R&D As a % of GDP 1985-2004	2,57	1,48	1,53	2,63
General public financial liabilities As a % of GDP 1985-2005	60,6	70,7	59,1	66,5
Social Outcome				
Income of poorest 20% As a % of total income	9.0	7.4	6.6	5.4
Income of 20% wealthiest As a % of total income	36.4	40.4	43.6	45.8
Suicide rates Average males & females (WHO)	17,03	12,14	9,45	10,85
Population above Age 65, both sexes As a % op population 1985-2004	15,6	14,9	13,5	14.5
Education levels: %Tertiary attainment for age group 25-64 (1991-2003) both sexes	27,1	17,2	22,0	34,3
Self-employed as % of total employment 1990-2004	11,5	19,6	17,2	9,1
Fertility Rates % children born to women aged 15 to 49	1,74	1,49	1,89	2,04

Both Scandinavian and Continental European tax revenues rely predominantly on direct taxes. Scandinavia gets 65,4% of total taxes from profits, income, and social security contributions. This is more than 11,1% above the Anglo-Saxon countries with 54,3% only. This Scandinavian tax structure undoubtedly contributed to a more egalitarian society than in the UK and Ireland, who put more emphasis on consumption taxes than both continental and Scandinavian countries. The Scandinavian wealthiest 20% earn 36.4% only of all income as opposed to 40.4% in continental Europe and 43.6% in the Anglo-Saxon countries. However the effectiveness of the Scandinavian redistribution system seems to be moderate as the poorest 20% Scandinavians earn 9.0 % of total income; merely 2.6% more than the 7.4% the poorest 20% of continental Europeans earn.

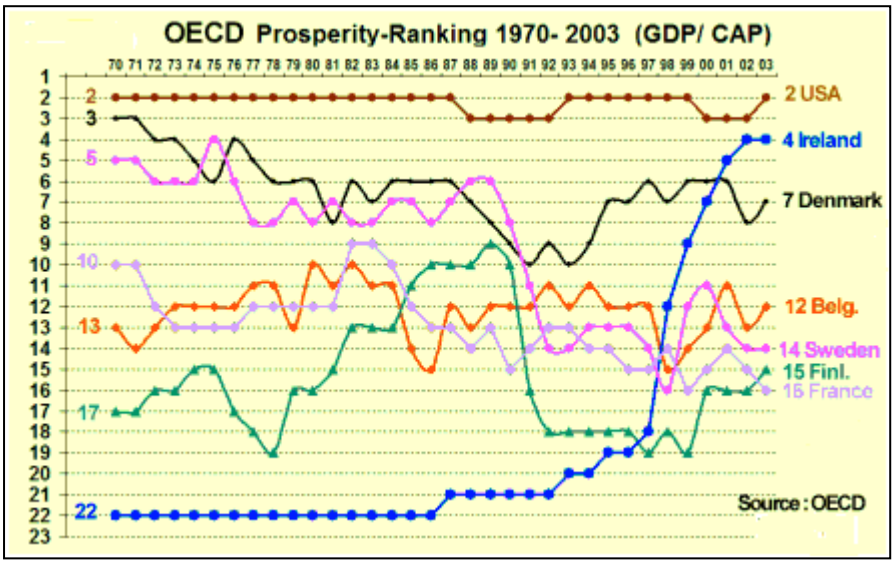
The Importance of choosing the right Policy Mix.

The empirical data over the last 20 years give convincing evidence that the European Anglo-Saxon model provides by far the best results as to progress of prosperity and as to the creation of new jobs, as well as in reducing poverty. Assuming these are the prime social objectives, the choice for the Anglo-Saxon social model seems obvious. With an average growth rate of 5.9% over the last 20 years particularly the Irish policy mix outperforms all others. The collectivist Scandinavian model, the continental European Social-democrat structure, both with their specific high government interference in the economy as well as the American laissez-faire policies all have all resulted in significantly slower growth and job creation. Ireland seems to have found the optimal synthesis between Scandinavian dirigism and American laissez-faire, the optimal equilibrium between extreme egalitarianism and inequality.

The Scandinavian social model with its wide range of social provisions has indeed proved to be unable to satisfy the citizen's deepest aspirations. Their egalitarianism does not contribute to increased well-being. Scandinavian suicide rates are nearly double the rates found under the Anglo-Saxon social model, and are well above those of continental Europe and the US. Very remarkably such extremely high suicide rates are also found in all former communist countries.[1] Psychologists have blamed this ultimate expression of extreme unhappiness to excessive government undermining the psychological foundations of personal autonomy. Being robbed of the most existential joys from their native capacity for enterprising, self-reliant rational behaviour, people seem unable to enjoy life without responsibility for one's actions and choices, and it is impossible to feel pride and independence without having the means to control one's life.

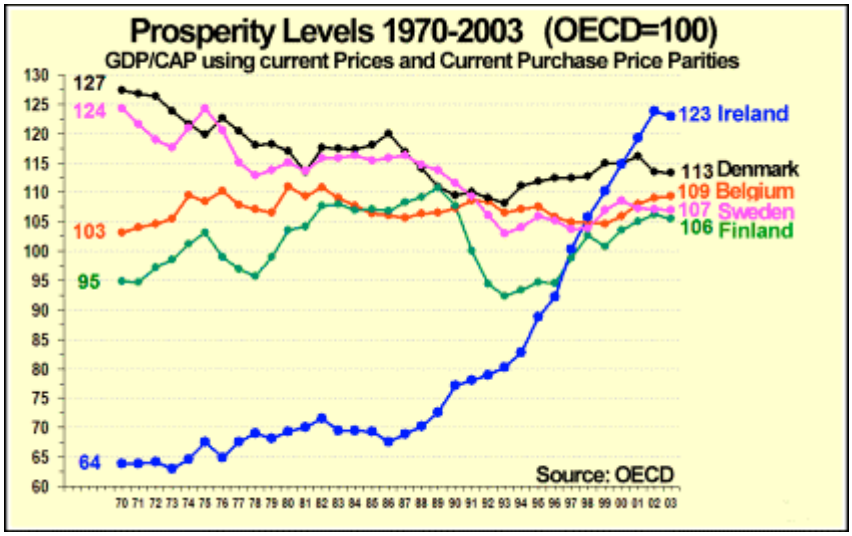
The overwhelming importance of choosing the right socio-economic policy mix is most evident when we compare the long-term growth differentials under different social models. We compare the evulution of prosperity and new job creation of Scandinavian countries with Ireland, and with a typical continental European country: Belgium.

In 1970, Sweden occupied 5th place in the OECD prosperity ranking, with a wealth level 25% above Belgium's. By 2003 Sweden's prosperity had fallen to the 14th place, two places behind Belgium. In 1970, Denmark was the 3rd most prosperous economy in the world, immediately behind Switzerland and the United States. By 2003, Denmark had fallen to the 7th rank. Finland did badly as well. From 1989 to 2003, while Ireland rose from 21st to 4th place, Finland fell from 9th to 15th. Together with Italy, the three Scandinavian EU-members are the worst performing economies in the entire Union. Rather than taking them as an example, as Big-government-enthousiasts suggest, we should shun the Scandinavian recipes.

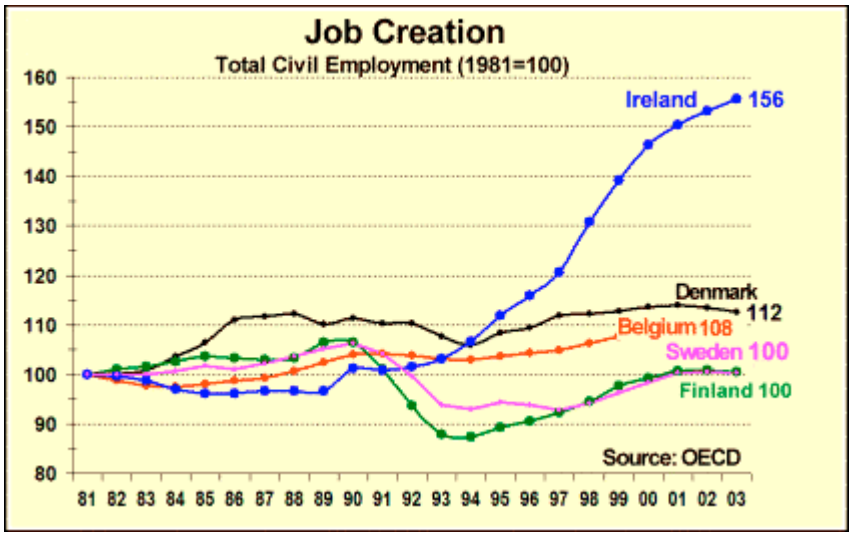


Danish Flexicurity unveiled.

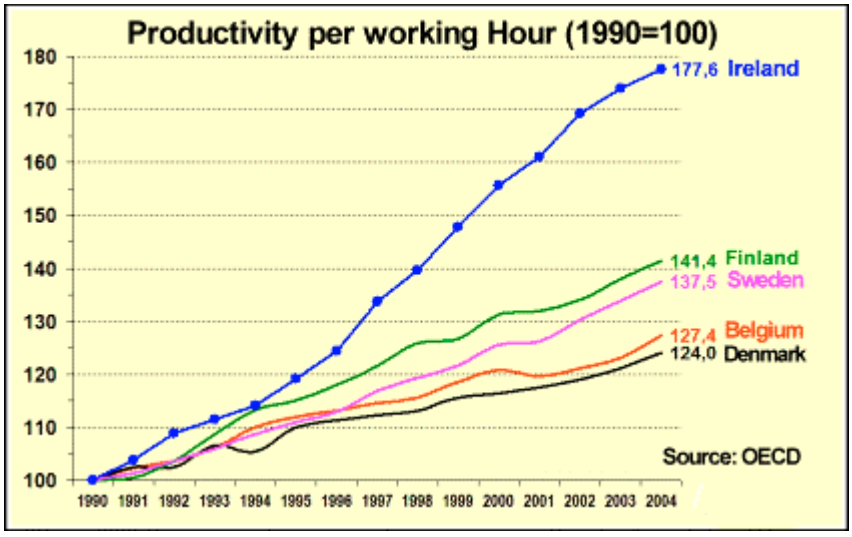
The poor Scandinavian performance is not limited to slow progress of prosperity. Their stagnation also resulted in extremely poor job creation over the last two decades. While The EU-15 averaged 24% new jobs jobs between 1981 and 2003, and while a moderately performing economy such as Belgium was able to increase its employment by 8%, Sweden and Finland could hardly create any jobs at all. Denmark performed marginally better with 12% new jobs in this period.



The strick Danish "flexicurity - policy" aimed at activating the labour market, made Denmark the best pupil of the Scandinavian class, and helped to lift Danish participation rates above the European average. Danish Flexicurity policy included measures such as easing hire-and-fire. For workers in the construction industry for instance the term of notice was reduced to no more than five days. Extremely merciless measures also such as unemployment benefits being restricted time, and young people as well as the long-term unemployed, being excluded from benefits if they refuse to accept low-paid, low-productivity jobs far below their level of education.



The strict Danish flexicurity measures certainly contributed to the much-needed flexibilisation of their rigid labour market, and were helpfull in curing the symptoms of the chronic unemployment disease. Flexicurity did however not remedy the deeper cause of the Scandinavian disease: namely deep frustration and profound de-motivation of both employers and employees as a result of the exorbitant tax burden.



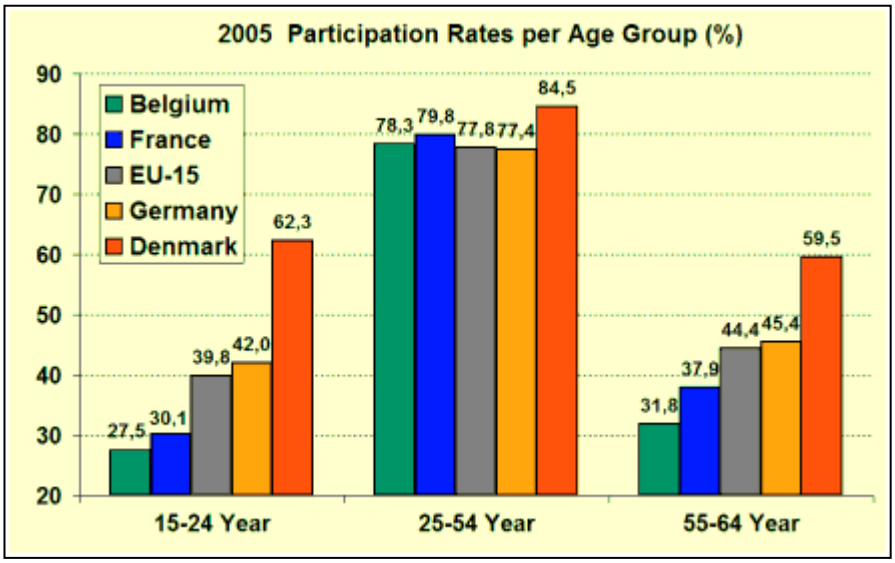
High Danish participation rates to a large extend are window-dressing, concealing much of the hidden unemployment. High numbers of partial jobs and pseudo-jobs in numerous activation programs as well as heavily subsidised employment are no longer accounted for in the unemployment statistics. Danish government officials also increased by no less than 240.000 (+37%) between 1996 and 2005[8]. Danish participation rates do indeed reflect much symbolic employment and hide the deficient initiative and investment from the overtaxed private sector and hide the total lack of productive jobs on offer. Flexicrity has been extremely painful for the workforce and was particularly merciless for the young and the elderly. However the positive wealth effects are hardly noticeable at all. Danish growth of prosperity and productivity remained substandard.

[8] see datasets 'Earnings in local governments (LON41-45)' en 'Earnings in central government (LON31-35)', www.dst.dk
http://www.itinerainstitute.org/Sites/ItineraInstituteBe/Assets/MEMO/memo5.pdf

The pressure on the unemployed to accept low productive jobs often lead to extremely low job satisfaction. High sickness absenteïsm has been the price to pay, as well as poor motivation at the job. As a consequence flexicurity in practice has gone at the expense of labour productivity and labour satisfaction, resulting ultimately in lower than proportional GDP growth. Hours per employed person are already significantly lower in Scandinavia (1590 hours only vs. 1644 in continental Europe), whereas Danish productivity per hour worked is lagging far behind Europe's average .

Flexicurity: an Euphimism for social Regression.

A closer look at the participation figures reveals how much the Danish overall participation rate is due to empoyment of the very old and very young age groups. Danish employment rate in the 15-24 year olds stands at 62.3% as opposed to 39.8% only for the EU-15 average. (source: Eurostat[9]). The social decline hidden behind Danish flexicurity is indeed painful. High Danish participation is in fact the result of very late retirement and early school leavers as a result of the very short Danish school duty. Danish School duty is in fact limited to a mere nine years of education whereas Danish legislation allows to employ children as young as 15 years in full legality. [10]



The Danish flexicurity model is far from being the social paradise some want us to beleive. Late retirement, early school leave, loss of job security, and shrinking leasure and time for a decent family life are todays social costs to pay by the Danish workforce for having kept an oversized Government in place for a couple of decades. Flexicurity is nothing more than window dressing for decades of creeping social regression resulting from excessive government spending, public waste and excessive public interference with the economy.

Recent Danish policy change

The Danish policy aimed at increasing participation rates through legal enforcement obviously had little success neither in boosting growth and prosperity nor in creating productive jobs. The main reason behind the Danish failure has been overtaxation and overregulation. The lack of incentives have deeply demoralised the Danish private sector. Overtaxation and overregulation has deterred industry form investing and creating the truly productive jobs needed to provide the non-inflationary financing people's wages. The IMF has recently warned against the Danish window-dressing and the flexicurity euphoria. Even the Danes themselves finally realised that social regression through labor enforcement is not the way to proceed, and that Big Government is the cause of the Scandinavian Desease.

In 2002 Danish policy makers finally introduced some principles of the Irish social model in their economic policy. In 2002 Denmark decided a public spending freeze implying that taxes, whether expressed in fixed nominal krone terms or in percentage terms, cannot be raised. An important element in the new fiscal strategy was to set strict targets for the growth of public consumption. Under the new fiscal strategy, the key target variable for public consumption was set at a maximum growth of 0.5% per year from 2005 to 2010. The target is thus markedly lower than the projected growth of the economy. Under a nominal tax freeze, inflation and growth gradualy and steadily are reducing the tax burden, both in real terms and as a share of GDP.
Public spending which still stood at 54.9% of GDP in 2002 is due to fall to 50.8% in 2007. At this rate of change, the size of Danish government could be reduced to the OECD average of some 40% by the year 2015. So in the end the Denmark might become the fairy-tale social paradise after all. Not by virtue of their long praised flexicurity - Big Government model, but because in 2002 the Danes deciced to dump the ballast from their antique, oversized wellfare system and to introduce some of the the modern free-market principles of the Irish Model.

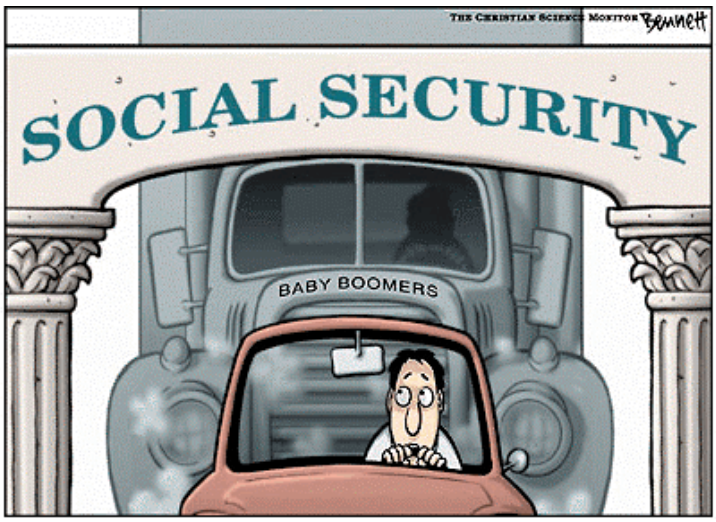
[9] http://epp.eurostat.ec.europa.eu/portal/page?_pageid=1996,39140985&_dad=portal&_schema=PORTAL&screen=detailref&language=en&product=sdi_as&root=sdi_as/sdi_as/sdi_as_pub/sdi_as1320

[10] http://www.right-to-education.org/content/age/denmark.html

Europe can no longer afford wrong Policy Choices.

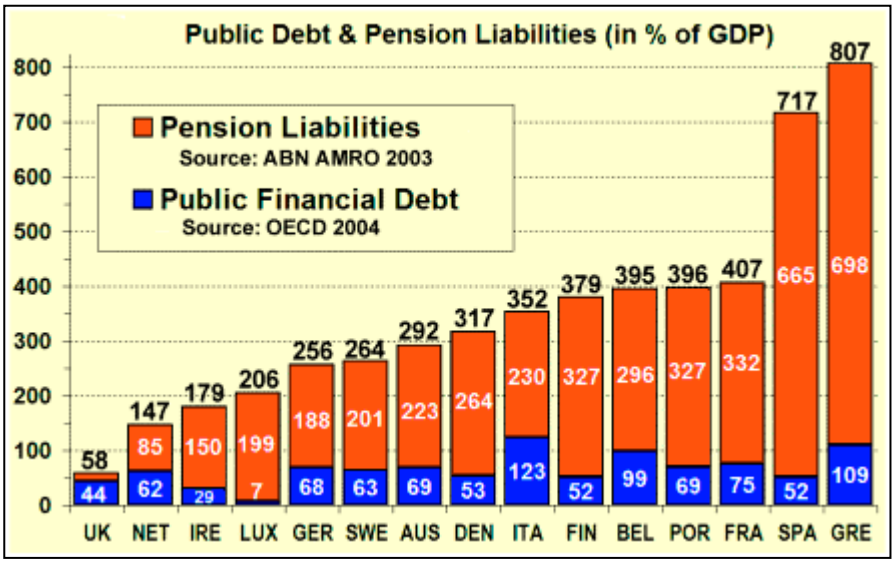
It's not that Europe has much policy choice left. Retirement benefits and Medicare costs will explode when the baby boomers retire, and that is in less than five years from now. Europe has made no or at the least fully inadequate provisions for the exponential rise of retirement benefits and health care caused by the longer life spans. The exponential rise of these costs will unavoidably exacerbate the tax-burden on our children if the European policy mix is not reformed.

It is not that ageing has come over Europe as sudden disaster. Demographers have been alarming the authorities since decades. Governments should have been starting to make provisions years ago. In stead, politicians of all colours denied the problem. The motto "Don't worry, be happy...." seemed a better strategy to electoral success. While debt was rising they continued to let the welfare state explode, inventing most crazy programs just to keep their electorate happy. In course of the process all European governments have been running the one record deficit after the other. Even under the Keynesian model, the idea is to run budget deficits during recessions and surpluses during recoveries. For half a century European governments have been running deficits in good times and bad, leaving the bill of their feast for future generations, that is, by those who have no say in the current political decision making.



The dramatic consequences of the massive indebtedness are systematically being covered-up. Whenever public debt figures given to the public, only part of the disaster is shown. Only financial debt resulting from the massive deficit spending is quoted. However real debt is many times greater and has reached proportions unequalled in history. The hidden liabilities accumulated in Europe's shortsighted pay-as-you-go public pension schemes exceed indeed several times the size of Europe's financial debt. Unfunded pension-liabilities now average some 285% of GDP (Petr Hedbávný, 2004 p 13) [11], more than 4 times the officially published financial debt figures. Total public liabilities exceed assets in most EU countries, and are causing runaway debt service.

Richard Disney (1998 p 31)[12] calculates that if social policies are kept unchanged, tax hikes of as much as 5 to 15 percentage points will be necessary over the next couple of decades merely to avoid the rate of indebtedness increasing any further. Unfortunately, this would just kill growth completely. As ever more (would-be) investors realise that new tax hikes in an already overtaxed Europe become unavoidable they will tend to turn their backs to Europe, and forget Europe as a potential investment site.



A basic idea behind sustainability is that one should leave a world to ones children that is at least as good a place to live in than one found it. Europe's social model does not match that criterion. On the contrary, it is based on the robbery of future generations. Keeping the system in place is continuing to jeopardise the next generation's future with an unbearable and uncompressible tax burden, adding to the risk of total collapse.

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[11] http://ies.fsv.cuni.cz/storage/work/504_wp55_schneider.pdf

[12] http://www.nottingham.ac.uk/economics/research/dp/school_dp/dp.98.20.pdf

Free Institute for Economic Research

THE PATH TO SUSTAINABLE GROWTH

LESSONS FROM 20 YEARS GROWTH DIFFERENTIALS IN EUROPE

Abstract

European countries have comparable states of industrial development, productivity, knowledge level and labour ethics. Yet economic performances differ notably. While economies like France and Belgium slowly progressed with 38% and 42% only from 1984 to 2002, Ireland's wealth grow at 4 times faster rate by no less than 167% over the same 18 year period. In barely half a generation Ireland evolved from the second poorest to the second richest country of Europe. The differences in new job creation are similar. The cause of these growth differences is found in different macro-economic public policy rather than in micro-economic differences between citizens and businesses.

PART 1 - *The Economics of Taxation*

In a first part of this paper, we discuss the newest developments in macro-economic theory and taxation policies. We have special attention for theory relative to optimising tax receipts by Laffer (1985) and the Barro-Armey theories (1990-1995) concerning optimising prosperity growth and income distribution. We compare the taxation policies in different social models, and have particular interest whether the Scandinavian model is suited for maximizing growth and creating new jobs.

PART 2 - *The Causes of Growth Differentials: Empirical Research*

In the second part we search for the causes of European growth differentials by means of multiple regression. The main conclusion is that two factors of the public policy mix cause weak growth performances: excessive taxation and a demotivating tax structure, on the one hand, and over consumption with a lack of savings and investment on the other hand. We conclude that the public sector in most European countries is far too large, leaving the private sector with too little recourse for it to achieve its potential wealth creation.

PART 3 - *Ireland versus Belgium : A Case Study*

In part three we make a case study and analyse performances of two countries with opposite public policies: Ireland's with low public spending and a flat tax structure and Belgium with high levels of public spending and a heavy direct tax burden. We analyse the effects on growth, budget, public debt, job creation and social expenditure. We conclude that only stimulation of the supply-side of the economy rescue Europe's generous social system and provide sustainable recourses for the challenges of its fast ageing population. This confirms the overwhelming importance of production and investment as the prime social objective.

Part 4 - *Loosing Overweight: A slimming Cure for fat Governments.*

In part four, we look at possible scenarios on how to reduce the public spending as the most effective way to restore dynamism and growth. On the basis of simulations we investigate the possibilities and consequences of a budget-freeze in real terms. We analyse whether pruning bureaucracy and the parasitical sector can free resources and return our workforce to its real task of creating wealth, and ultimately restore efficiency and competitivity of both private and public sector.

DOWNLOAD PART 2 - THE CAUSES OF GROWTH - EMPIRICAL RESEARCH

http://workforall.net/Causes-of-Growth-Differentials-Multiple-Regression.pdf