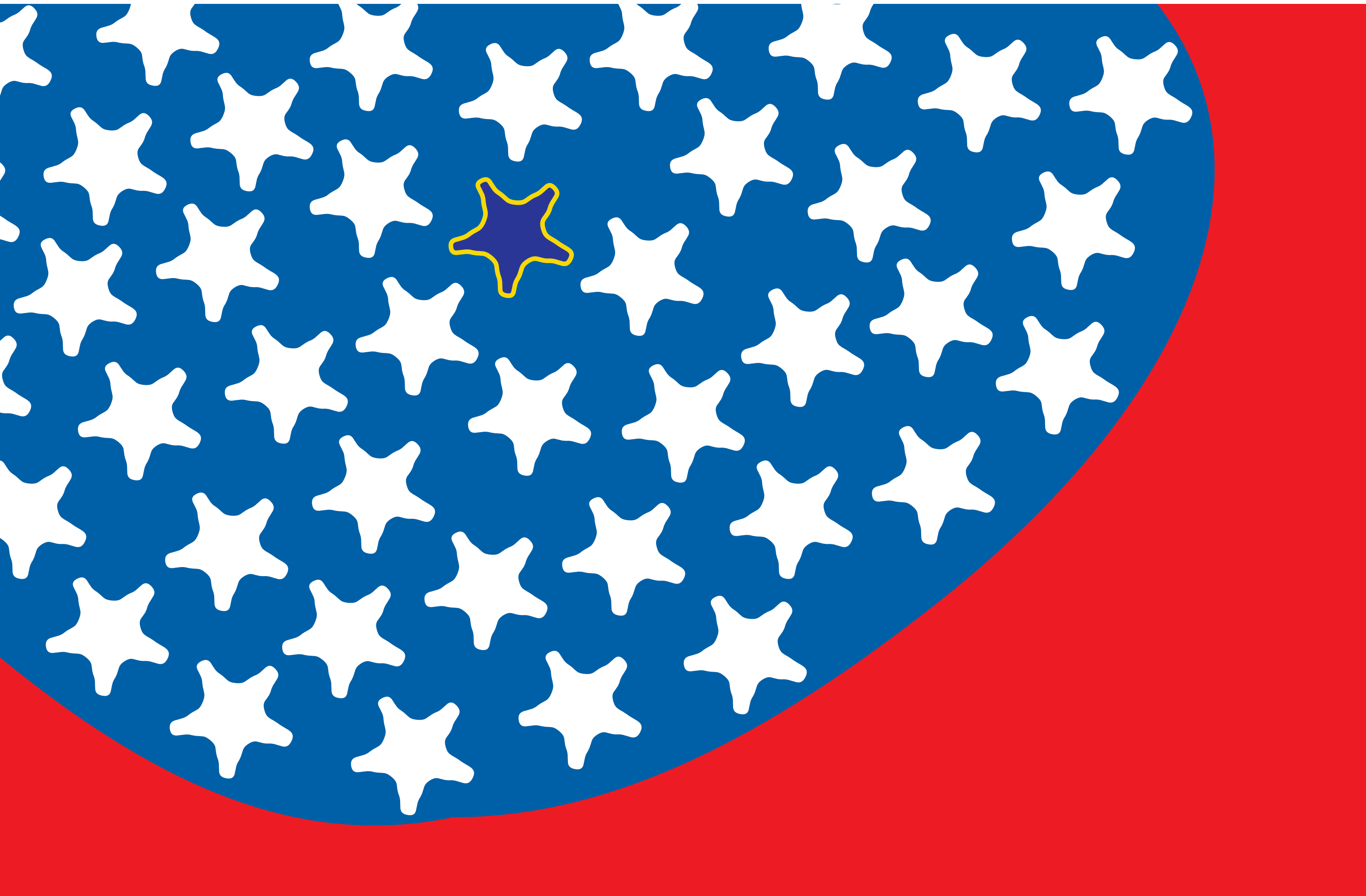
TIMBRO

EU VERSUS **USA**

Fredrik Bergström & Robert Gidehag



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TIMBRO BOX 5234 SE-102 45 Stockholm
FAX +46-(0)8-587 898 55
TEL +46-(0)8-587 898 00
info@timbro.se
www.timbro.com

PREFACE

IF THE EU WERE A PART of the United States of America, would it belong to the richest or the poorest group of states?

At the beginning of the 1990s, there was no need to ask. Europe's economic future was a subject of growing optimism. Productivity growth had for some decades been higher than in other countries of similar standing, and that growth was now going to be hugely accelerated by the elimination of trade barriers and the closer economic integration resulting from the Single Market. The EU as an institution was – and was undoubtedly *seen* as – a vehicle for growth and economic liberalisation. In other words, the EU was able to do what politicians in several member countries had wished for but had failed to achieve: to increase economic openness, to strengthen the process of competition, and harness the political process behind a liberal reform agenda.

Today, the perspectives on the EU, and the outlook on its future, are radically different. Economic growth during the 1990s never became what many had wished for. Some countries performed reasonably well, most notably Ireland, but on the whole the EU was lagging far behind other countries during the whole decade. Productivity growth decreased and by mid-decade the EU was running behind the US in this respect. The process of convergence in productivity, a much talked-about process since the 1970s, had once again become a process of divergence.

The role, and status, of the EU in the economic reform process has also changed. Instead of a clear focus on economic reforms and growth, the EU (the Commission as well as the Council) has concentrated its ambitions on other political objectives. Hence, the EU no longer is – or is seen as – the great economic liberator of Europe. It is generally not performing as a vehicle for reforms, nor as leverage for policies that are needed but impossible to accomplish in the national political arenas.

Is it possible to break the spell of economic stagnation in Europe? Yes, undoubtedly. But, alas, it seems highly improbable. The member countries have agreed on a relatively far-reaching reform agenda in the Lisbon accord (yes, in the modern European context it is far-reaching). But the agenda lacks impetus. Not to say a true awareness of the need of reforms. Worse still, many European politicians and opinion-formers seem totally unaware of the lagging performance of the EU economies and that a few percentage units lower growth will affect their welfare in comparison with other economies.

Such is the background to this study on the differences in growth and welfare between Europe and the US. Too many politicians, policy-makers, and voters are continuing their long vacation from reality. On the one hand, they accept, or in some cases even prefer, a substantially lower growth than in the US. On the other hand, they still want us to enjoy the same luxuries and be able to afford the same welfare as Americans can. Needless to say, that is not possible. But the real political problem is that lower welfare standards – as with inequality in general – are a relative measure for most people. They are always viewed by comparison with others, and rarely in absolute terms. People would rather weep in the backseat of a new Mercedes than in the backseat of a second-hand Volkswagen.

This study is based on a widely acclaimed and thought-provoking book – *Sweden versus the US* – that was published earlier this year in Swedish by the same authors – Dr. **Fredrik Bergström**, President of The Swedish Research Institute of Trade, and Mr. **Robert Gidehag**, formerly the Chief Economist of the same institute, and now President of the Swedish Taxpayers' Association. The study presents important perspectives on European growth and welfare. Its highlight is the benchmark of EU member states and regions to US states. The disturbing result of that benchmark should put it at the top of the agenda for Europe's future.

Fredrik Erixon
Chief Economist, Timbro

CONTENTS

1. INTRODUCTION

THIS REPORT IS ABOUT THE FACT that per capita GDP is lower in most of the countries of Europe than in most of the states of the USA. That France, Italy and Germany have less per capita GDP than all but five of the states of the USA is probably something that messrs Chirac, Schröder and Berlusconi don't wish to know. Or that Göran Persson is prime minister of a country which, if it were a part of the USA, would rank as one of the very poorest states in that Union? Can this be true? Is it plausible? It is both true and plausible. America's GDP is far higher than Europe's and has been so for a long time now, and the American economy has been growing faster than the economies of many European countries in recent decades, not least those of countries like France, Germany and Sweden. The US recession, with GDP growth rates of 1 or 2 per cent, represents almost boom conditions in Germany, for example. Europe may have its Eiffel Tower in Paris, its Coliseum in Rome, fine roads in Germany and social security systems in Sweden, but it will take more than past achievements to cope with the economic challenges which many European countries are facing. Economic challenges which among other things will be brought about by demographic developments and will impose heavy strains on comprehensive, publicly funded welfare systems.[1]

Europe not having the same economic development as the USA, then, is a problem to the citizens of Europe, in that lack of good economic development prevents resources from being generated as profusely as they could. Resources which could be applied to augmenting opportunities for improving the material quality of life. Good economic growth is not only of importance for private purchasing power, it also creates better prospects of the public sector providing collectively funded services, because the tax base grows faster in a growth economy than in an economy with less growth.

European economic debate is bedevilled among other things by a lack of insight into the real gravity of the situation in many European countries, and especially in many of the countries which have had far-reaching ambitions in the realm of welfare policy. Lack of insight means a risk of necessary growth reforms not being introduced. One important reason for this lack of insight is that to many people the debate conducted by economists on per capita GDP growth is too abstract and abstruse. How many people know, for example, what GDP measures and how much they themselves contribute towards GDP growth? One of the overarching purposes of this report is to concretise in various ways the implications of differences in GDP and in GDP development for ordinary people. To

[1] See Stein (2004) "The importance of demographic changes – Economic, financial and social changes in an ageing society", paper presented in Hamburg at the Mont Pelerin Society's regional meeting.

further concretise the importance of economic growth, we also propose comparing the countries and regions of Europe with one of the world's richest countries, namely the USA and its member states. Comparison of European countries with states of the USA is warranted by the USA being a very big country with big regional differences. Comparison of Belgium or Sweden with the USA is not the only interesting comparison to be made. These countries should also be compared with regions of the USA which are more similar to themselves. It is fairer, for example, to compare Sweden with the old Swedish settlements of Minnesota or Illinois.

Another reason for taking a closer look at the states of the USA is that some of them have greatly outstripped the national development average. Benchmarking – comparing oneself with those who are "best in class" – is common practice in the world of business enter-prise, its purpose being to highlight differences and to learn as much as possible from doing so. Closer comparison between the European countries and the USA can show what poorer long-term economic development implies, and also the implications of a future improvement in economic growth. Perhaps Europe has something to learn from the USA when it comes to creating favourable conditions for an efficient market economy.

The report starts off, in chapter 2, with a general comparison between the USA and Europe, based above all on per capita GDP and private consumption statistics. In chapter 2 we also discuss how the countries of Europe come off when compared with states of the USA. In chapter 3 an attempt is made to concretise the significance of the GDP concept by relating it to more concrete yardsticks of material standard, such as wages and household incomes. Chapter 3 also shows that poverty is very much of a relative concept. Being poor in an affluent country is, materially speaking, a lot better than being poor in a poor country. In the concluding chapter a number of possible causes are highlighted which can help to account for the USA being a far richer country than most of the countries of Europe.

The Appendix gives, for each of the countries discussed here, a commentary on its standing compared with the states of the USA.

2. EUROPE VERSUS USA

THIS SECTION IS INTENDED TO SHOW, by means of concrete comparisons between official statistics, how Europe is lagging behind the USA. GDP figures provide the main point of departure.

These statistics are compiled and presented in concrete terms far too seldom. Deplorably, knowledge concerning the true magnitude of the differences between the USA and Europe stays within a narrow circle of economists and others addressing the issues in their everyday activity, but there are debaters who attach the utmost importance to synthesising and presenting official statistics for a wide readership. Only then can EU citizens put pressure on their politicians for the serious implementation of growth-stimulating policies.

Probably we are now passing through a period when relative prosperity – meaning prosperity compared with that of other countries – is getting more and more important. Formerly, the fact of our own country growing wealthier with the passing of time was, presumably, sufficient to inculcate a feeling of improved prosperity. Each new generation was better off than its predecessor, and that went a long way. Comparison with other countries meant less. Globalisation, in the broad sense of the term, has changed all that. People now have an insight into culture, technology and patterns of consumption worldwide, and so they are comparing themselves in different ways from previously. The countries developing the best technology, new forms of medical treatment and the most environment-friendly, child-safe cars etc. will be made more and more of a yardstick. Normally, people are no longer content with having better medical care than thirty years ago. Instead they want to have the best care imaginable in an international perspective. Then again, countries are trading with each other more and more. The stragglers are going to find it increasingly hard to participate in this process on the same conditions as the more affluent countries.

Let us begin by describing in simple terms what GDP is about. GDP is a flow variable measuring the value of a country's total annual output. That which all the individuals in a society produce in the course of one year makes up the resources available for various kinds of consumption and investment that year. Obviously, a country with many inhabitants will have a bigger GDP than a smaller country with a smaller population. To allow for this, GDP is divided by the number of inhabitants in each country, to give what is called per capita GDP. GDP is the commonest way of measuring material prosperity and the only criterion for which there is widespread consensus and co-ordination regarding the measuring procedure to be followed.

Before making any comparisons, we should observe a number of problems involved in comparing GDP figures. Basically, GDP has a number of shortcomings as an indicator of prosperity. In the first place, it captures only the part of production which takes place in the market sector and is therefore statistically recorded. Output in the black (illegal) economy and the unrecorded output of households themselves are not recorded. Potentially this is a major problem. Several studies have indicated an extensive black economy in several modern industrial nations.[2]

Another problem concerns the focus of GDP. In an efficient market economy, production, theoretically speaking, will correspond to the population's preferences concerning the direction of output. Due, however, to malfunctions of the market and, not least, to political interference, it is to be expected that production will partly go in the "wrong" direction. This will entail losses of welfare. Child care subsidies, for example, can lead to heavier consumption of this service than would be the case if people were allowed full control of their own spending.

Another, increasingly heard objection is that GDP is strictly a material yardstick, paying no regard, for example, to the value of leisure or a good environment. If people were induced to work twice as hard, GDP would rise, but of course this would not necessarily mean greater happiness and wellbeing for the individual. Production processes which destroy the environment can sometimes raise GDP without the cost of the environment destruction being factored into the GDP calculation. Equality is another of the "intangible" values which GDP does not take into account. The overwhelming majority of all economists would, presumably, agree that there is some form of contradiction between equally shared prosperity and rapidly growing prosperity. Rapid GDP growth, then, is not the be all and end all of happiness and prosperity, given the conviction of equality being a good thing in itself. If anything there is here a manifest conflict of aims, the resolution of which is very much a question of values. There has been more and more discussion lately of various indexes aimed at measuring other aspects than GDP alone. These indexes also factor in equality, for example, in a calculation of total national wellbeing. The obvious problem about them is that they are extremely sensitive to the choice and weighting of the variables included. In other words, these indexes are extremely arbitrary. In Sweden, for example, an index of this kind presented recently by a statistician of left-wing persuasions showed Bulgaria coming higher than the USA in terms of wellbeing. Such methods and indexes are patently absurd.

Having said this, GDP remains the best and commonest yardstick of material prosperity at macro level. There is considerable international co-ordination today as regards how to GDP is to be measured and what it must include. And the fact is that material resources, which in the ultimate analysis are generated by an efficient, fast-growing economy, are a precondition of much of the wellbeing which people like to call intangible. The level of GDP is probably a better measure of wellbeing than most of the different welfare indexes which have been devised and which attempt to factor progressively more and increasingly

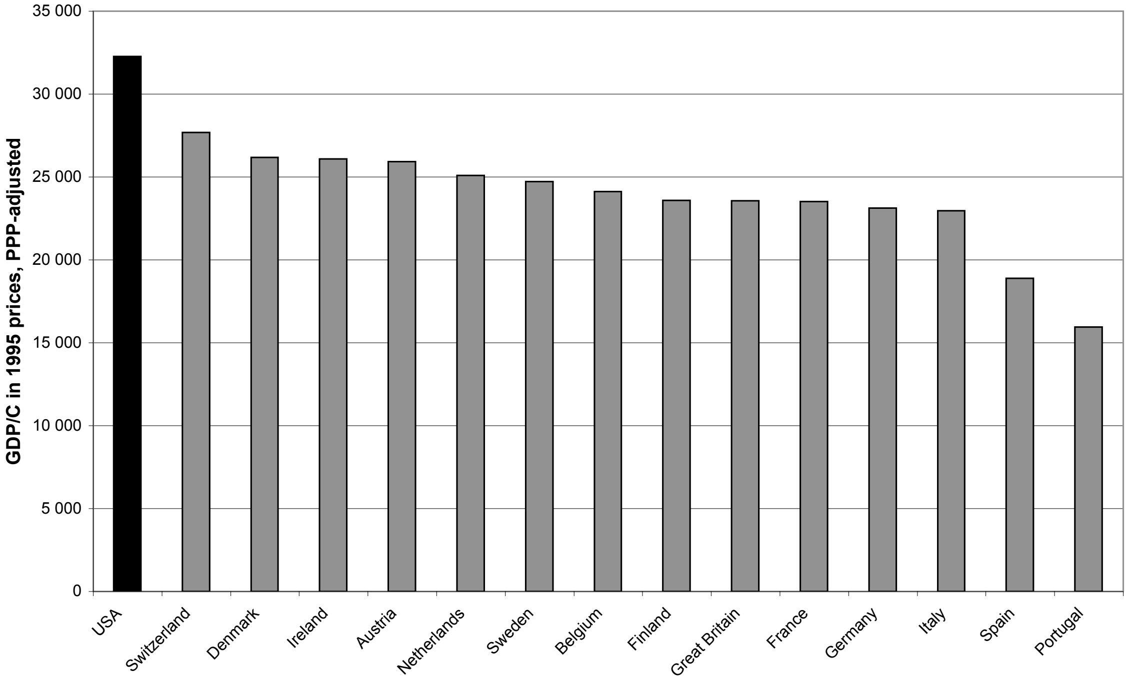
[2] See Schneider (2000) for at review of methods for measuring the black economy and its performance.

arbitrary factors. Studying migratory flows between countries, which must be regarded as a measure of the true prosperity of different countries as actually measured by people, we have a very strong feeling that people tend to move from poorer to richer countries (in per capita GDP terms) rather than to the countries characterised by other factors which are customarily included in various indexes of welfare.

2.1 The USA is richer than Europe

Today there is a relatively big difference in economic prosperity between the countries of Europe and the USA. Per capita GDP is appreciably higher in the USA.

Diagram 2:1. Per capita GDP in the European countries and in the USA, 2000, current prices and PPP-adjusted.



Source: Eurostat.

As can be seen, the USA is far and away ahead of all the European countries. Next comes Switzerland, a relatively extreme and, for Europe, misleading example, owing to the heavy flows of foreign capital it receives. Even so, the difference in per capita GDP between the USA and Switzerland is 17 per cent. Next comes a whole clutch of countries in the middle of the GDP hierarchy, all of them relatively far behind the USA.

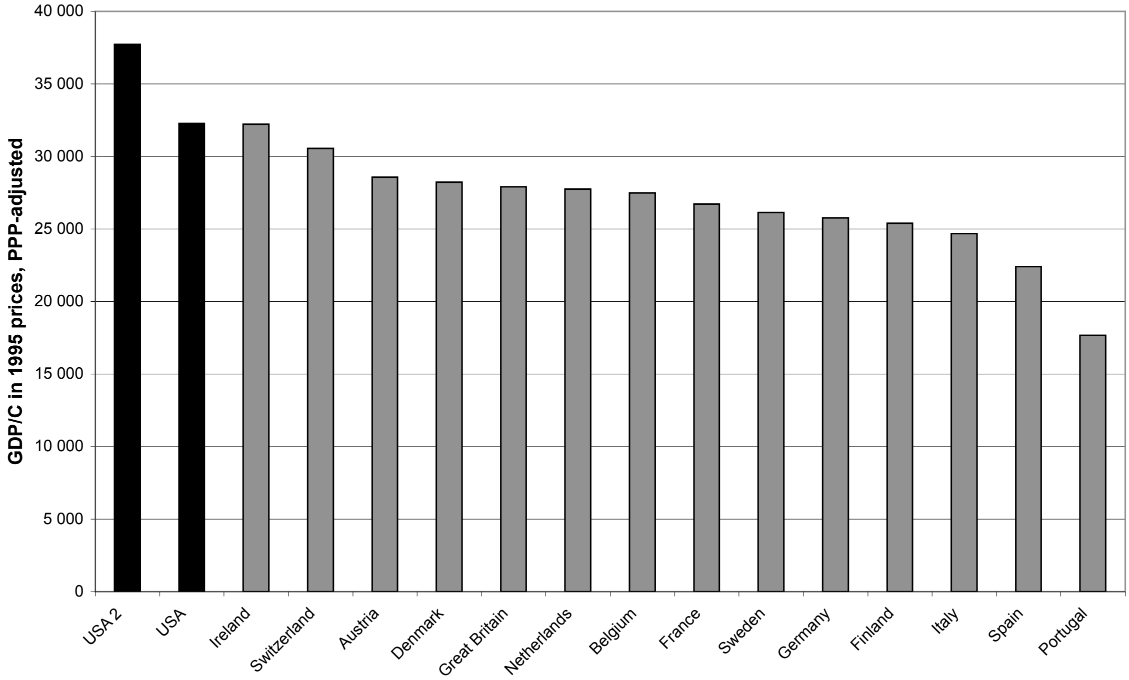
2.2 The odds are, Europe will be a long time catching up with the USA

The true magnitude of the gaps is amply illustrated by Diagrams 2:2 and 2:3. The gaps already existing today are so great that, even if the European countries were to suddenly being growing much faster, it would still take them a long time to catch up with the USA.

This kind of gap is not susceptible to short-term cyclic processes. Catching up would take the European countries far longer.

Diagram 2:2 shows the Eurostat per capita GDP forecasts for the European countries in 2005. Two GDP levels for the USA have also been included, namely the actual level in 2000, and a forecast for 2005, based on American growth being as fast as it was between 1995 and 2000.

Diagram 2:2. Per capita GDP (current prices, PPP-adjusted) in Europe, 2005, as per Eurostat forecast, US per capita GDP in 2000, and US per capita GDP as per historical forecast.



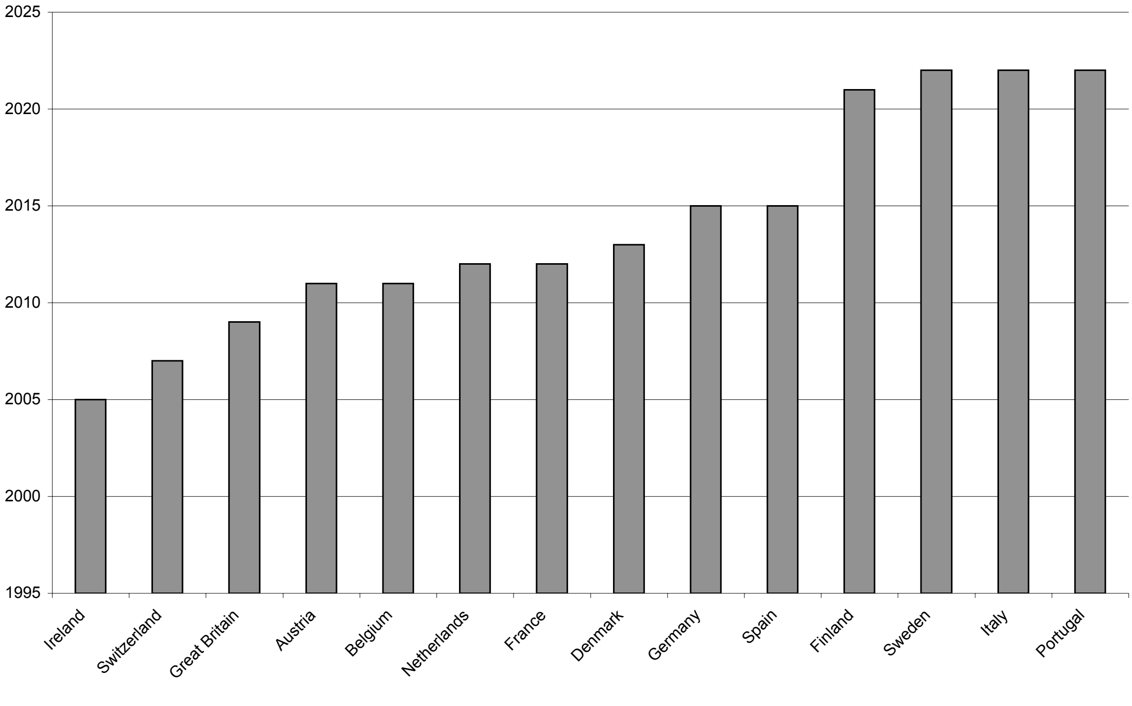
Source: Eurostat and own calculations.

The "USA" column, then, is the American economy in 2000, i.e. a scenario with zero percentage growth in the USA. The extremity of this assumption is above question. Probably, moreover, it would lower the growth of the European countries, given their dependence on the American economy. The "USA 2" column illustrates a scenario with the USA growing at the same rate between 2000 and 2005 as between 1995 and 2000. One very interesting observation is that one country alone catches up with the USA in 2005, assuming the American economy to be at a complete standstill, and that country is Ireland. Five years' growth in the other European countries will still not suffice to catch up with a wholly stagnant American economy.

If the American economy is allowed to grow at the same rate as between 1995 and 2000, the differences will increase still further. Comparing the USA with the average for the European countries (the average excluding the two richest and two poorest of the European countries), the gap widens between 2000 and 2005 from 32 to 39 per cent. Diagram 2:2, in other words, illustrates the fact of there being a very wide gap between the USA and most of the European countries. And the trend is for this gap to keep on widening all the time.

A further conjectural instance is shown in Diagram 2:3. Here as in one instance in Diagram 2:2, the American economy is kept constant at the same level as in 2000. In addition, the Eurostat forecast for the European countries in 2005 was used for calculating an average annual growth rate in these countries for the five-year period between 2000 and 2005. Assuming each European country to have this average annual growth rate, we can work out how many years it would take to catch up with the American economy.

Diagram 2:3. The year when European countries have caught up with the American economy, given that the American economy is frozen at 2000 and growth in the European countries conforms to the Eurostat forecast.



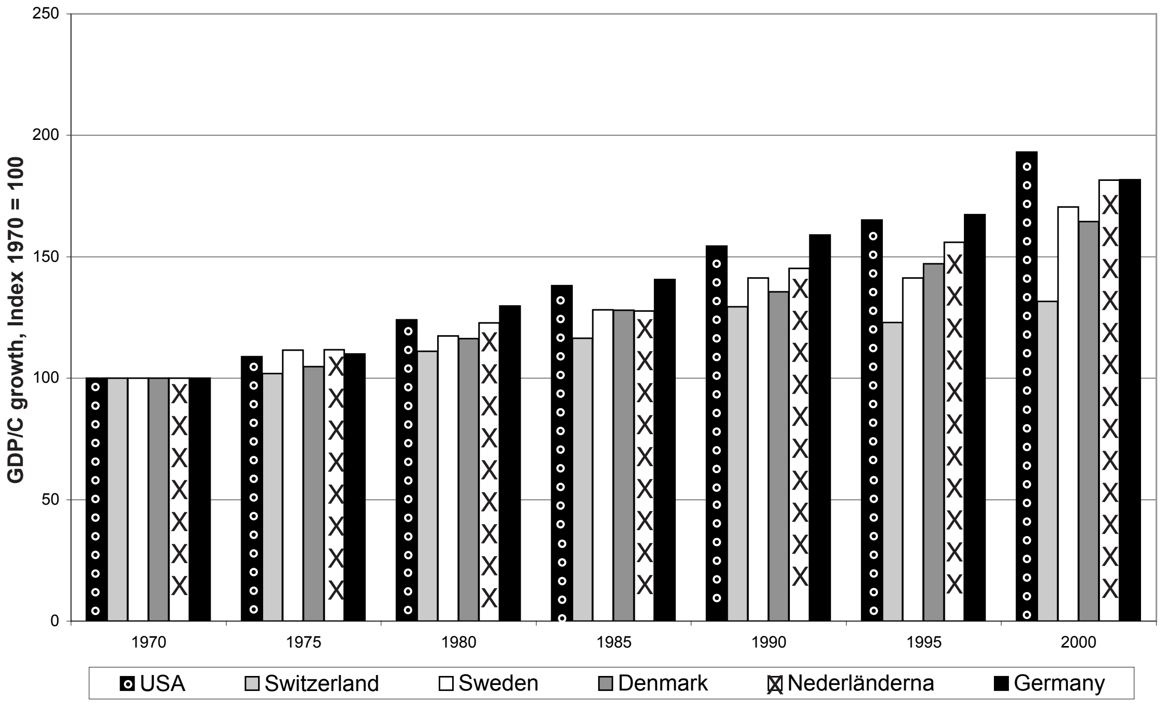
Source: Eurostat and own calculations.

As we saw earlier, Ireland is the first country to catch up with the USA, in 2005. Otherwise Switzerland and the UK are the only countries to catch up with the stagnant American economy before 2010. Seven European countries take until 2015 or longer to catch up with the USA. Sweden, for example, does not come up to the American level until 2022. Once again, the differences between the American and the European economies are very great, so great that most of the European countries will need 15 years of normal growth to catch up on the American economy as it now stands.

The high level of the American economy in 2000 as we have now described it has resulted from a slow, gradual process over a long succession of years, during which the American economy has all the time been growing somewhat faster year by year than the European economies. The success of the American economy is much more a matter of higher average annual growth than of casual cyclic phenomena or short- rapid growth cycles.

Quite simply, the USA has succeeded with something in its growth policy (or rather, absence of policy) where the European countries have not. Diagram 2:4 shows the six wealthiest countries among the USA and Europe in terms of per capita GDP in 1970. Economic growth (per capita GDP) in fixed money terms has then been calculated for the period and an index created with 1970 as its base year.

Diagram 2:4. Per capita GDP growth index (fixed money terms, PPP-adjusted) for the period 1970–2000 in the USA and the five richest European countries in 1970.



Source: OECD.

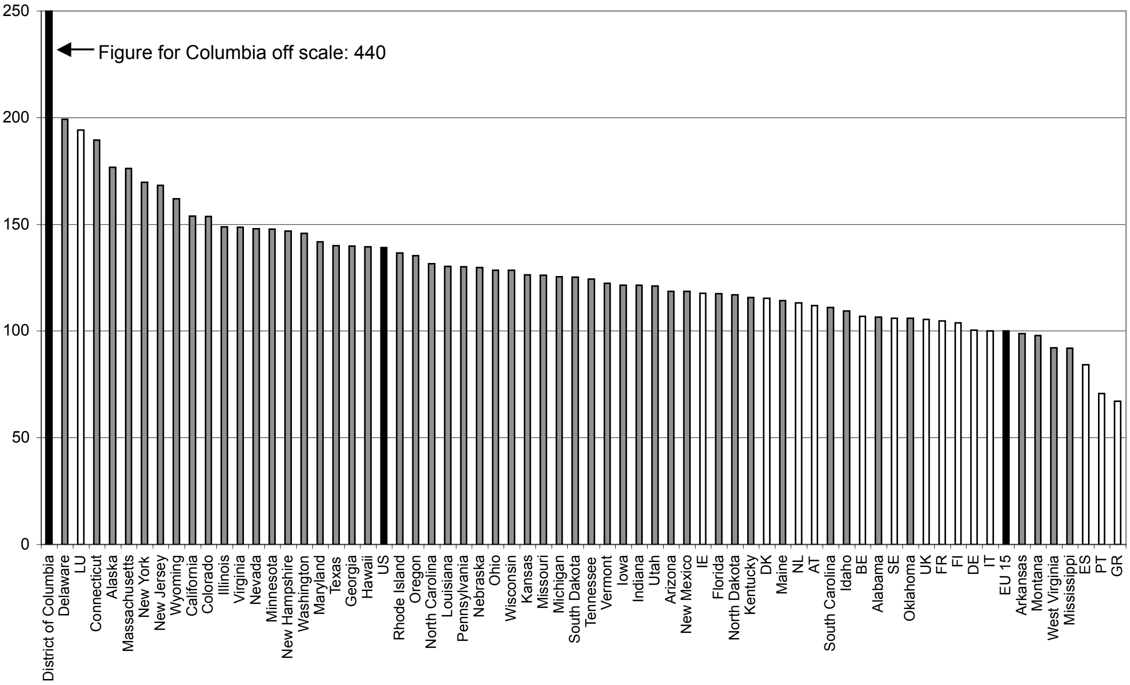
Note that Diagram 2:4 illustrates GDP growth in fixed money terms for the period. As the diagram shows, the USA has performed best in this group of the six richest countries in 1970. Certain other countries with a considerably poorer starting position have grown faster than the USA in the past 30 years, but these are countries which were relatively poor to begin with and are thus favoured by catch-up effects. The USA has for a long time been a growth machine which Europe has difficulty in matching, and so the gap between the two continents tends to widen over time.

2.3 Many European countries have lower per capita GDP than the majority of states in the USA

This comparison with the USA as a whole is of course interesting as a point of departure, but it is important to remember that the USA is an entire continent. It includes geographically defined regions which can present considerable differences in prosperity, growth and circumstances, and so the comparison between Europe and the USA can be deepened by comparing states of the USA with European countries. That comparison too makes dismal reading from a European viewpoint.

Diagram 2:5 ranks all the states of the USA and the European countries in terms of per capita GDP in 2001 (fixed money terms, PPP-adjusted).

Diagram 2:5. Per capita GDP in the states of the USA and in the EU 15 in 2001, PPP-adjusted, index EU 15 = 100.



Source: Eurostat and Bureau of Economic Analysis.

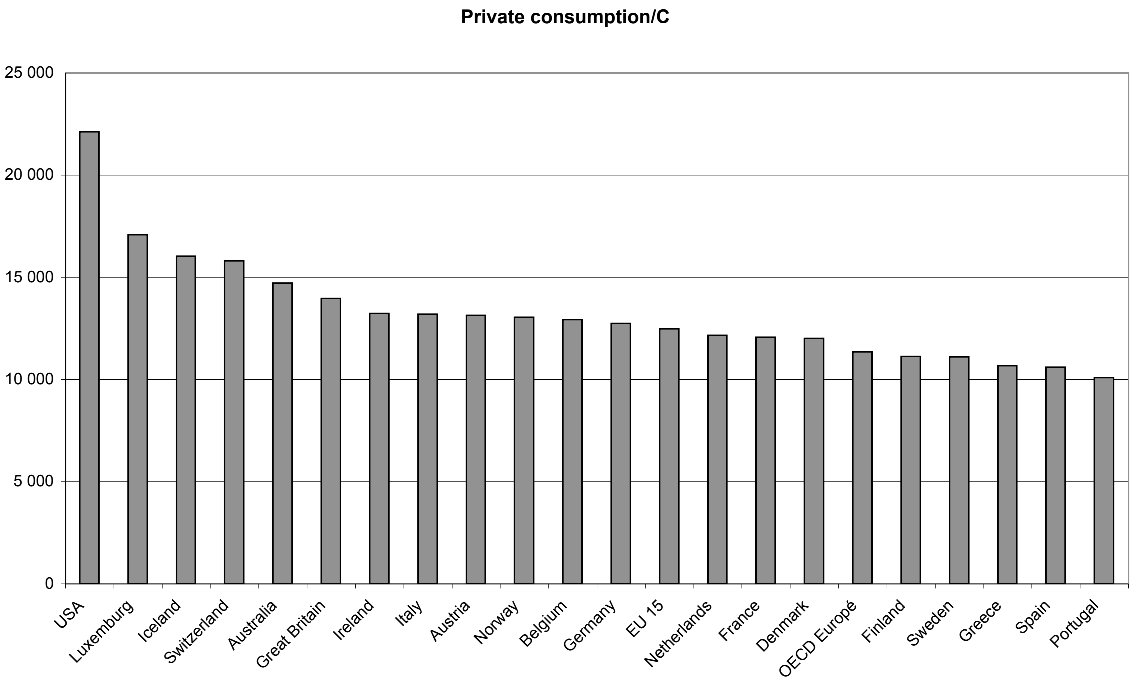
As this diagram shows, there is really just one European country which can rival any of the states of the USA, namely Luxembourg. The success of that country can to a great extent be put down to a heavy inflow of foreign capital. All the other European countries come in the lower half of the scale. There is a very wide gap – something like 100 per cent – between the great majority of European courtiers and the more affluent states of the USA. Connecticut, for instance, has almost twice the material prosperity of old European great powers like France and the UK. Only four American states are relatively poor by European standards, but here the differences are nothing like as great. The Appendix also shows how different regions in the European countries relate to the states of America. Consistently there are certain European regions (many of them metropolitan) which come off relatively well by comparison with the states of the USA. Other regions often have a per capita GDP below the poorest states of the USA.

2.4 High incomes coupled with low taxes mean high private consumption in the USA

So much for GDP comparisons. Private consumption is another important welfare indicator. Basically this is a question of people deciding their consumption for themselves, the possibility of riding in a new, roadworthy car, the food we eat, the number of pleasant and time-saving restaurant visits, the possibility of experiencing creative leisure, and so on. Access to the new products of technical progress is every bit as important today as it ever has been. Take, for example, the importance of having access to a computer and the Internet, or being able to "buy time" by consuming good precooked food or services.

Diagram 2:6 shows private consumption, which of course is closely bound up with GDP development. In an economy with high per capita GDP, incomes will be high, which in turn elevates private consumption. Inter-country comparisons of private consumption, however, are beset with the same kind of difficulties as comparisons of available income. Different countries' choices of public commitment influence, through taxation policy, the scope available for private consumption, at the same time as high taxation countries, through their public sectors, offer some of the things recorded in low taxation countries as private consumption. There is no easy way of getting round this, but it is an important point to bear in mind when comparing private consumption.

Diagram 2:6. Private consumption in 2000 in fixed money terms, PPP-adjusted, in the USA and European countries, USD.



Source: Statistics Sweden (SCB).

Per capita private consumption is far higher in the USA than in most European countries. American private consumption is 29 per cent higher than in Luxembourg, the country with the highest private consumption in Europe. Compared the average (EU 15), the difference in consumption is very great. In the USA the average person spends about 9,700 more on consumption annually, a difference of 77 per cent. The average American, in other words, spends nearly twice as much (77 per cent more) on consumption as the average EU citizen. This is due to a higher level of GDP but also to taxation policy. Allowance for tax differences would reduce these big differences somewhat, but American consumption would still far outweigh its European counterpart.

2.5 Retail consumption is higher in the USA

High per capita GDP coupled with internationally low taxes means a high level of private consumption for the Americans. A substantial part of private consumption goes on retail commodities. Table 2:1 shows retail sales in the USA and Sweden.[3] On the whole, though, the difference tallies with the picture that has emerged already. Americans have higher incomes and lower taxes and can therefore have a retail consumption which is SEK 30,000 greater per annum and per capita than is possible in Sweden. A vital difference, giving the Americans far greater opportunity to buy better goods and more of them than people in Sweden can.

Table 2:1. Retail sales in Sweden and the USA.

		PRIVATE CONSUMPTION		
	GDP	Total	Retail trade	Sundry
USA	307,000	206,000	69,000	137,000
Sweden	223,000	113,000	38,000	75,000

Source: GDP and private consumption figures come from OECD Economic Outlook, 2001:1.
Retail sales are taken from US Census (table 1 under http://www.census.gov/svsd/www/artstbl.html)
and Swedish retail sales from HUI. SEK /USD = 7,65 (May 2004).

The higher level of retail consumption means that the Americans have more "gizmos" than Europeans. A conspectus by Cox and Alm (1999) shows American households to have far more domestic appliances, television sets, computers, telephones and cars than in most European countries; se Table 2:2. This again tallies with results shown earlier.

[3] Note that there may be differences in the definition of retail sales, so that the figures are not necessarily 100 per cent comparable.

Table 2:2. Percentage of households in different countries owning various domestic appliances etc.

	USA	Belgium	Denmark	France	Germany	Italy	Netherlands	Spain	Sweden	Switzerland	U.K.
Clothes Washer	**90**	88	74	88	88	96	89	87	72	78	88
Dishwasher	**53**	26	36	32	34	18	11	11	31	32	11
Microwave	**86**	21	31	19	36	6	22	9	37	15	48
Radio	**99**	90	98	98	84	92	99	95	93	99	90
Television	**98**	97	**98**	95	97	**98**	95	**98**	97	93	**98**
Clothes Dryer	**82**	39	30	12	17	10	27	5	18	27	32
Vacuum Cleaner	**99**	92	96	89	96	56	98	29	97	93	98
VCR	**83**	42	63	35	42	25	50	40	48	41	69
Personal Computer	**40**	22	30	20	20	14	25	11	29	23	25
Phones per 100 people	63	46	61	56	49	43	53	39	**68**	61	50
Cell phones per 1 000	12.4	23.2	157.3	23.8	42.8	67.4	33.2	24.1	**229.9**	63.5	98.0
TVs per 1 000	**776**	464	536	579	550	436	495	490	476	461	612
Autos per 100	**57**	41	31	42	49	51	38	Na	41	44	3

Note: Figures in bold type indicate that the country has the highest percentage of households owning the product in question.

Source: Cox & Alm (1999, table 5.2, p. 97).

Clearly, then, there are very big differences between the American and European economies. A long period of high growth has made the USA far and away the world's richest region. For several centuries Europe led the world in terms of prosperity and progress. As little as a hundred years ago, much of the American continent was virgin wilderness. Today, a hundred years later, the USA has completely overtaken Europe to become the unrivalled leader of the world economy. Most Americans have a standard of living which the majority of Europeans will never come any where near. The really prosperous American regions have nearly twice the affluence of Europe. It is worth reminding ourselves what this means. In these regions the average American can get exactly twice as much of everything as the average European. Which goes to show the importance of an economic policy to stimulate growth.

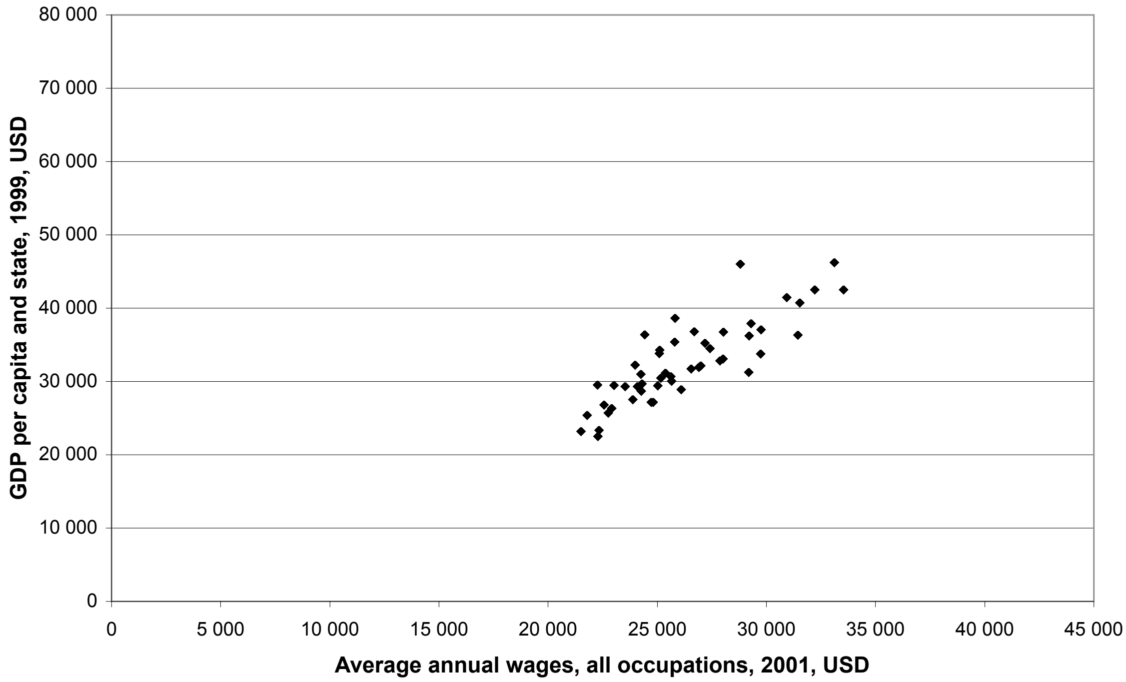
3. GDP AND ECONOMIC PROSPERITY – ANY CONNECTION?

AS WE SAW EARLIER, PER CAPITA GDP is an abstract measure of economic prosperity, and one purpose of the present report is to show in other ways why good GDP development contributes towards a higher economic standard of living. In this chapter we will be taking a closer look at the states of the USA. Thanks to the big differences between the various states, we can investigate the extent of the connection between GDP level and less abstract indications of economic prosperity. For example, are wages higher in states with a higher GDP level, are household incomes higher and is the proportion of low-income households smaller? By studying indicators of this kind, GDP differences can be brought to life. The European countries have not been included in this analysis, the reason being that different measures of income have to be carefully examined before comparisons can be made between different countries. This has been done for Sweden; see Bergström and Gidehag (2004). The conclusions from comparisons of this kind can then be directly translated to European conditions. In this chapter we will also be looking more closely at a number of variables describing the living standard of the poor in the USA, since one often hears it said that, high as the level of the US economy may be, many people there are very poor. As we shall see, however, the poverty concept is a very relative one, and poverty in the USA is associated with a surprisingly high material standard of living.

3.1 Good economic development helps to improve wages

Putting it simply, there are two ways in which a country can achieve good economic development. Citizens can work more, and they can work more intelligently, the latter meaning that they act in an efficient economy which effectively utilises their work input in the best possible way. Both these factors help to increase annual earnings. Many have doubtless heard tell of how much many Americans earn and how much one can gain by migrating to the USA. It is claimed, for example, that a graduate engineer moving to the USA can double his salary, and high salaries are one reason for many researchers joining American universities. As can be seen from the concluding chapter of his book, Americans not only earn more, they also work more than Europeans. Better pay combined with higher hourly rates adds up to bigger annual wages. Diagram 3:1 shows the connection between per capita GDP and average annual earnings at state level. As can be seen, there is a strong connection between GDP level and average earnings. We conclude, in other words, that in an efficient, growing economy annual wages will be high and will rise parallel to the growth of the economy – a truism almost, and as valid for Europe as it is for the states of the USA. If the Europeans had worked harder and more intelligently, their annual earnings would have been higher.

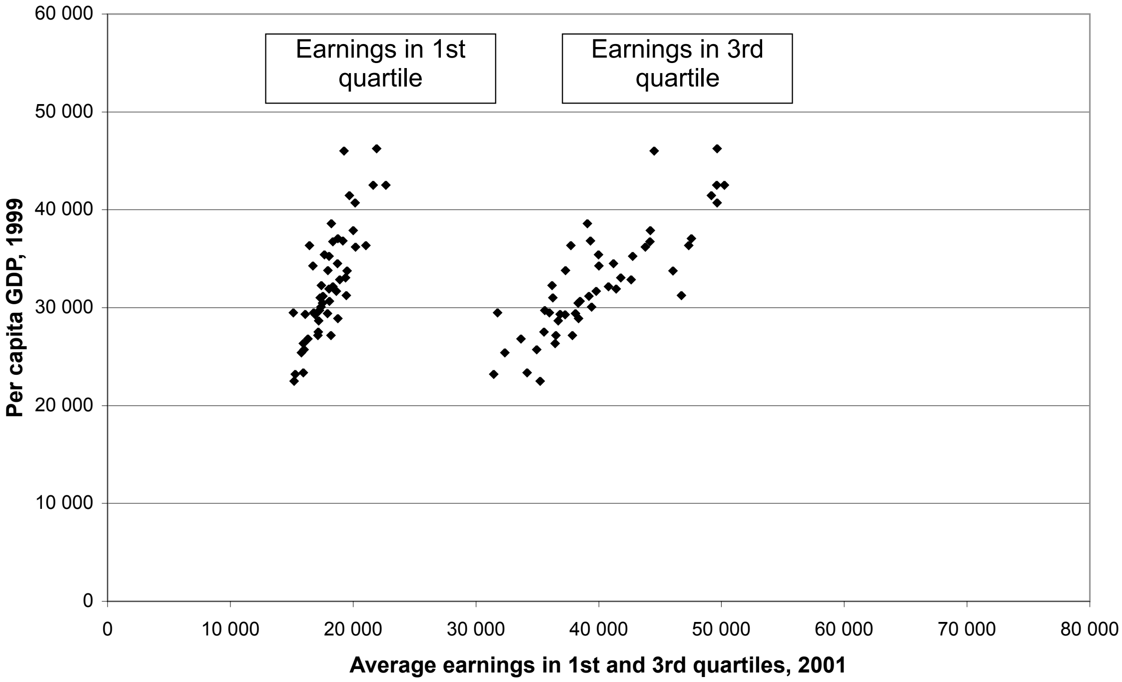
Diagram 3:1. Connection at state level in the USA between average earnings (2001) for all occupations and per capita GDP (1999), USD.



Sources: Bureau of Labor Statistics, Bureau of Economic Analysis.

The available material concerning annual earnings in the USA also includes information about the level of earnings for the first and third quartiles respectively, i.e. for low income earners and for people who are relatively well paid. Diagram 3:2 shows the connection between per capita GDP and these two wage classes. As can be clearly seen, the connection is strong one. The higher per capita GDP, the higher earnings will be – a connection applying to both low and high income earnings and also valid for Europe.

Diagram 3:2. Connection at state level between earnings in the 1st and 3rd quartiles respectively (2001) and per capita GDP (1999), USD.



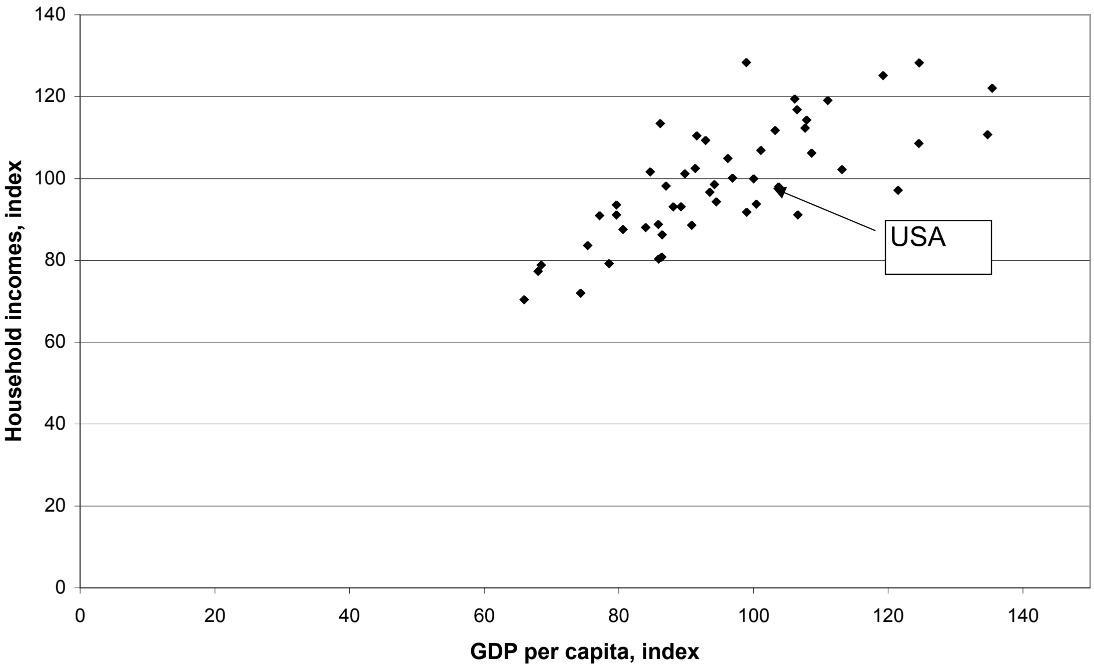
Sources: Bureau of Labor Statistics, Bureau of Economic Analysis.

3.2 High wages mean high household incomes

If there is a positive connection between per capita GDP and wage levels, then a positive connection should also exist between per capita GDP and household incomes, in that the greater part of those incomes are earnings. In Diagram 3:3, per capita GDP in all the states of the USA has been plotted against median household incomes in the states.

As can be seen, the connection between per capita GDP and household median incomes is a strong one. Diagram 3:3 implies that the level of GDP (and with it historical GDP growth) has an effect on household incomes. Good economic development leads to higher incomes. Consequently, if comparable measures of income for European countries were to be plotted in the diagram, many of them would come among the states of the USA with low per capita GDP and low household incomes.

Diagram 3:3. Per capita GDP and household median incomes per state of the USA. Index: USA = 100. 1998/1999.



Sources: US Census, Bureau of Economic Analysis.

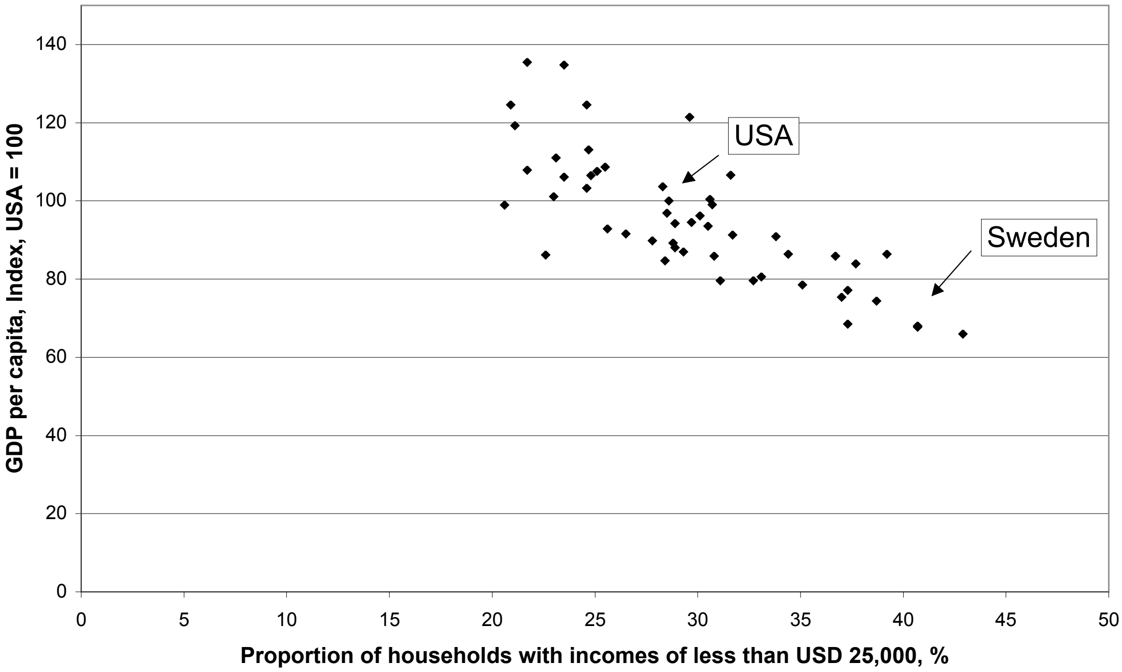
3.3 Good economic development leads to fewer low-income households

Good economic development with a commensurately high level of per capita GDP can also be expected to help reduce the proportion of low-income households. Whether or not this will be the case depends on how incomes are distributed, and if a growing GDP is not too unevenly distributed, the number of low-income households should also decline as the level of the economy improves. Diagram 3:4 shows the connection between per capita GDP and the proportion of households, in each state of the USA, with a household income of less than 25,000 dollars. This level has been chosen because 25 per cent of all American households in 1999 had a household income of less than 25,000 dollars, i.e. it measures the proportion of low-income households. The diagram also includes observations for Sweden and the whole of the USA. Sweden has been included to illustrate how a European country comes off by comparison with the USA and its member states.[4]

This diagram reveals a clear negative connection between the level of per capita GDP and the proportion of households with incomes of less than 25,000 dollars. Low per capita GDP also leads to an increase in the proportion of low-income households. In other words, there is a strong connection between the relatively abstract yardstick of per capita GDP and household incomes.

[4] Note that the household income measurement employed is a gross measurement comparable with the American measure of household income; this point is discussed further in Bergström & Gidehag (2004, chap. 4).

Diagram 3:4. Connection between per capita GDP and proportion of percentage of households with annual household incomes of less than 25,000 USD, 1999.



Sources: US Census, Bureau of Economic Analysis, Statistics Sweden (SCB) and own calculations.

3.4 It is better being poor in a rich country than in a poor one

Poverty is a highly relative concept. As we saw in the preceding section, for example, 40 per cent of all Swedish households would rank among low-income households in the USA, and an even greater number in the poorer European countries would be classed as low income earnings by the American definition. In an affluent economy, in other words, it is not unlikely that those perceived as poor in an international perspective are relatively well off. The media image of the American poor is that they have great difficulties to contend with, that they are dossers, junkies and in various ways marginalised. There are of course such groups in the USA, and they are relatively large, but – and this is an important "but" – such groups exist in European countries too. There is also another image of poverty in the USA, namely that the great majority of those considered to be poor have a relatively good material standard of living. Examples are given below.

First of all, the percentage of poor people in the USA has diminished over time, concurrently with the growth of the American economy; see Table 3:1. In 1959, for example, 22 per cent of all Americans were living below the then poverty line. Today only 12 per cent are living below the present-day poverty line. Things have also improved for the black population of the USA, whereas for Hispanics the poverty percentage has changed little since 1972.[5]

[5] At the same time it is worth noting that income differences have increased over the past 20 or 30 years. This, however, has been mainly a matter of the rich getting richer, not of poor growing poorer. A similar development has characterised the majority of European countries. For an analysis of Sweden, see Bergström & Gidehag (2001).

Table 3:1. Poverty percentages, various ethnic groups.

	1959	1999
Whites	18	10
Blacks	55	24
Hispanics	23 (1972)	23
Total	22	12

Source: Caplow, Hicks, Wattenberg (2001).

What does it mean to be poor in the USA? Major living standard surveys carried out in the USA at regular intervals show the poor to have a surprisingly high standard of living; see Table 3:2. A large proportion own their homes and have one or more cars. Domestic appliances of different kinds are also relatively common, as are one or more TV sets complete with video or DVD. Material prosperity, in other words, is high and not associated with the material standard of living which many people in Europe probably associate with poverty. Good economic development, in other words, results in even poor people being relatively well off. Quite simply, it is better to be poor in a rich country than in a poor one.

Table 3:2. Percentage of poor households.

	Percentage of poor households		Percentage of poor households
Home ownership	45.9	2 or more colour TV sets	55.3
Car	72.8	Cable or satellite TV	62.6
2 or more cars	30.2	Wide screen TV	26.3
Air conditioning	76.6	Video or DV	78.0
Refrigerator	96.9	2 or more video and DVD players	25.3
Washing machine	64.7	Stereo	58.6
Drying cabinet/tumbler drier	55.6	Telephone answering machine	35.3
Dishwasher	33.9	Mobile phone	26.6
Garbage disposal	29.7	PC	24.6
Microwave	73.3	Internet access	18.0
Colour TV	97.3		

Source: Rector & Johnson (2004).

Another indicator of the relatively good material standard of living among the American poor can be obtained by comparing dwelling space among poor households in the USA with average dwelling space in Europe. Table 3:3 compares dwelling space in various countries. Average total dwelling space in Europe is just under 1,000 sq. ft. In the USA it is 1,875 sq. ft for the average household and 1,200 sq. ft for poor households. Adjusting for size of household, one finds that poor households in the USA have slightly more dwelling space than the average European. The average American household has a home that is 80 per cent larger than its average European counterpart. Europeans, in other words, are more crowded in an American perspective.

Table 3:3. Dwelling space. Various countries.

Country	Survey year	No. persons per home	Dwelling space, square feet	Dwelling space (square feet) per person
Austria	2000	2.4	974.9	406.2
Belgium	1991	2.5	928.6	371.4
Denmark	2001	2.1	1171.8	558.0
France	1996	2.5	946.9	378.8
Finland	2000	2.1	823.1	392.0
Germany	1998	2.2	932.9	424.0
Greece	1991	3.0	856.5	285.5
Ireland	2001	3.0	950.1	316.7
Italy	1991	2.1	971.6	462.7
Luxembourg	2001	2.6	1345.0	517.3
Netherlands	2000	3.4	1054.5	439.4
Portugal	1998	2.2	893.1	279.1
Spain	1991	3.3	917.8	278.1
Sweden	1997	2.1	966.2	460.1
UK	1996	2.4	914.6	381.1
Europe, average		2.5	976.5	395.7
USA, poor households	1993	2.8	1,228	438.6
USA, all households	1993	2.6	1,875	721.2

Source: Rector & Johnson (2004).

4. WHY EUROPE LAGS BEHIND – A QUALIFIED GUESS

BY ANY METHOD OF MEASUREMENT, EUROPEAN economic development has been relatively poor over the past thirty years, which of course prompts one to ask: Why?

Trying to understand the causes of growth has for ages been a priority concern of economic science. Adam Smith pointed out the importance of division of labour and specialisation, and by the same token to the importance of free trade. He also stressed the importance of rights of ownership and good incentives. Some researchers have pointed to the importance of capital formation and work, while others have shown growth to be determined not only by the quantity of labour and capital but also by their quality and how well they are utilised. The role of human capital, for example, has been highlighted. More modern institutional research has reverted to Adam Smith's original insights concerning rights of ownership and the importance of other institutional conditions. This latter research tradition has also emphasised the role of politics as the creator or wrecker of good conditions for the growth process.

4.1 High taxes are not without their problems

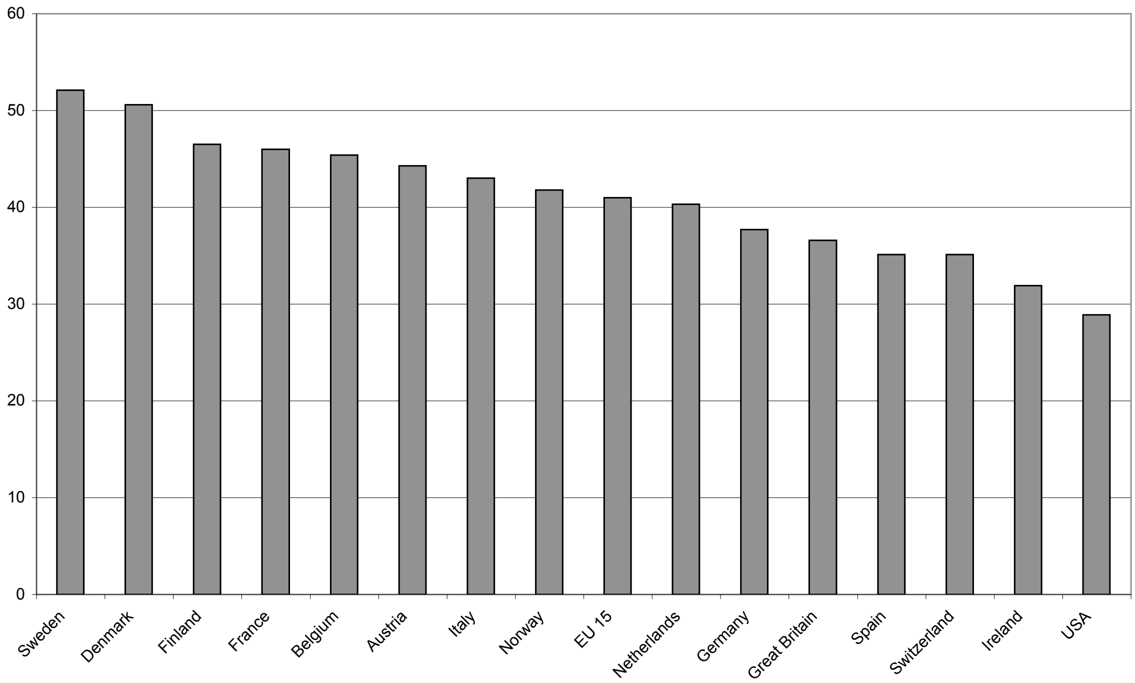
When we turn to consider the impact of economic policy on growth, it is hard not to notice that one particular factor above all is essentially different in large parts of Europe compared with the USA, namely the expansion of the political sphere in general and taxes and the size of the public sector in particular. Economists may disagree as to the demonstrability of a connection between, say, pressure of taxation and growth – and concerning the strength of that connection, if it does exist – but one cannot altogether ignore the fact that Europe (or at least, large parts of it) has chosen an essentially different path from the USA, at the same as the American economy has grown considerably faster. We belong to the economists who believe that this is not a coincidence and that, on the contrary there is a relatively strong connection involved here.[6]

[6] Our picture, even so, is that the overwhelming proportion of research in this field finds a negative connection between taxation pressure and growth. Many of the researchers arguing the difficulty of finding a general connection also put this down mainly to problems of measurement. Pressure of taxation is a general measurement in which many things are included. Within the structure of two equal pressures of taxation, for example, there may be essentially different marginal effects. If poorer countries are included, a bogus connection may appear between rising pressure of taxation and increased growth, since it is common for demand for services which are normally financed out of taxation revenue to increase when the economy grows.

This, of course, is because, the higher the tax burden and the larger the public sector become, the greater will be the power of political decision-makers and public bureaucracies. Private players, consequently, will have less scope for deploying their in-comes and assets as they themselves wish to. High taxes also generate counter-incentives to work and entrepreneurial initiative. The larger the public sector is, the more dependent the population will also be on public transfers and the smaller will be the portion of the economy open to competition. This, as we shall be considering in the present section, has a negative impact on economic growth. The tax burden and the size of the public sector are indicators of the extent to which an economy is a market economy or an economy directly and indirectly subject to political decision-making.[7]

Let us illustrate how the American economy differs from most of Europe where tax burden is concerned. The pressure of taxation is an indicator which tries to capture the size of public commitment. All taxation revenue is aggregated and viewed in relation to GDP. The picture for 1999 is shown in Diagram 4:1. The picture has changed little since then.

Diagram 4:1. Tax burden as a percentage of GDP in the USA and Europe, 1999.



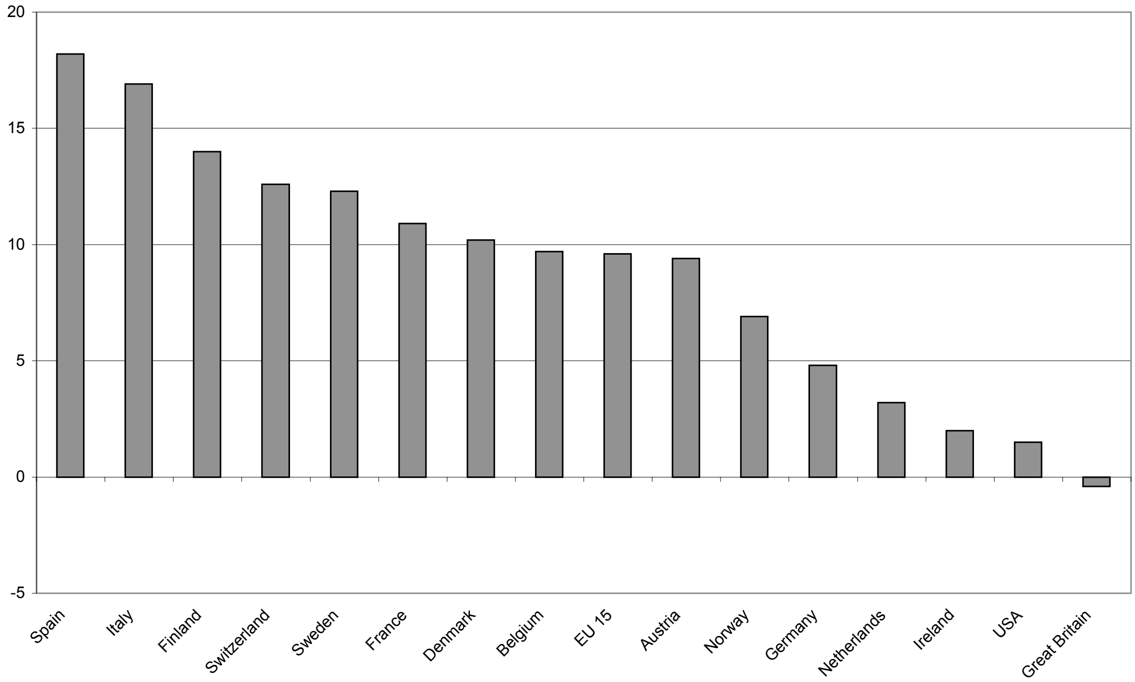
Source: OECD.

[7] At the same time it is again important to remind ourselves that two equally high pressures of taxation can inflict different degrees of harm on the economy, depending on how they are imposed. Basically this is a matter of how marginal effects and tax wedges impact on the economy. Similarly, structural differences in the public sector and transfer systems can affect the workings of the economy in different ways. Further to this point, see Molander (1999).

As will be seen, the USA comes last while, not unexpectedly, the Scandinavian countries top the ranking list for pressure of taxation. There is a very great difference between the USA and these countries. But the USA has a substantially lower tax burden than in large parts of Europe, the difference between the USA and the EU average (for the EU 15) being no less than twelve percentage units. It is quite natural to argue that the USA and Europe have taken very different paths where public sector expansion is concerned.

This becomes perhaps clearer still if we analyse the change occurring in the tax burden since 1970. Diagram 4:2 shows how the tax burden changed between 1970 and 1999 in the countries compared.

Diagram 4:2. Change in tax burden (percentage units), 1970–1999.



Source: OECD.

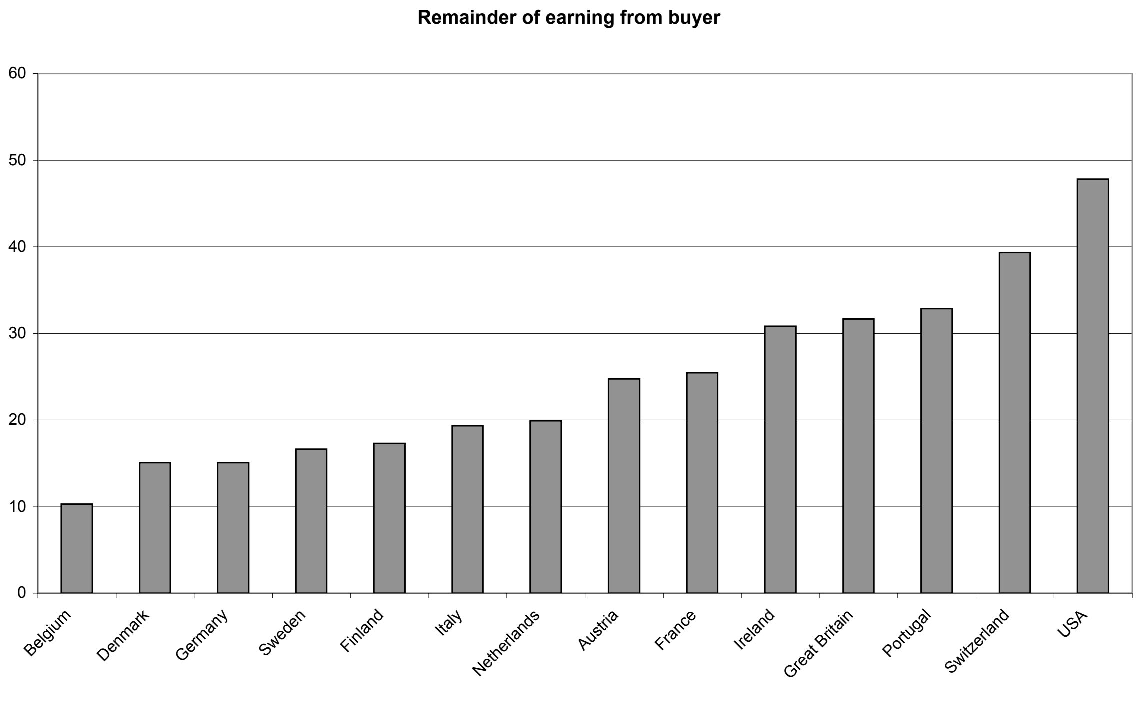
One country, the UK, has actually reduced its tax burden. Taxes in the USA and Ireland have risen very little during the period in question. Tax burden in the USA has risen by a marginal 1.5 percentage units in 30 years. As we all know, large parts of Europe have chosen a different path, and expansion of their public sectors has really put on speed over the past 30 years.

This expansion has made more and more private economic deliberations dependent on public decision-making. The return on education, the difference in economic benefit between working or living on handouts, or the possibilities of starting up and running a business all hinge to a very great extent on political decisions. This, to a very great extent, is the situation in Europe as compared with the USA.

4.2 High tax wedges give the wrong incentives

It is of course important not only to analyse taxes at macro level. Europe's generally high tax burden and its extensive welfare systems have created big marginal effects and tax wedges. In many European countries, the taxation system interposes a very big wedge between what is privately and nationally remunerative. Diagram 4:3 shows the percentage of the money paid by the purchaser of a service actually making its way into the service provider's wallet. As can be seen, there is a big difference between large parts of Europe and the USA. Note that our calculation is based on the total tax wedge. The seller's income is taken to include social security charges, and the money ending up in the seller's pocket is net income after all taxes have been paid. Due to the account being based on this, in a manner of speaking maximum calculation, tax wedges will always be very high.

Diagram 4:3. Percentage of the buyer's income entering the service vendor's wallet (inverted tax wedge).



Source: Karlson, Johansson & Johnsson (2004), p. 184.

The tax wedge can be termed very high in at least nine European countries. At most, in this group of nine countries, the seller of a service is allowed to retain 25 per cent of the income generated by the purchaser of the service. There are several countries where the tax wedge exceeds 80 per cent. A taxation system like this naturally results in resources in the economy being wrongly used. Here again, the USA is in a class of its own. Even with all taxes and charges included, the seller of a service retains nearly 50 per cent of the total original income from the buyer. Thus not only does the USA have a lower general tax burden, its tax wedges are also appreciably lower.

High tax wedges are an undesirable consequence of high tax policy, very much due to the great technical difficulty of constructing a taxation and benefit system without marginal effects. But there are also more intentional effects of the European welfare state which can entail growth problems. Fundamentally, growth is created at micro level. It is a matter of people's everyday decisions whether to go to work or stay at home, whether they are spurred to invent things and run businesses, whether they are to educate themselves and work hard or go in for a rewarding leisure, whether they are to work overtime or go home.

4.3 Equalisation policy and a large public sector also have their problems

High taxes are used in many European countries to finance a comprehensive welfare system having redistribution as its main purpose. Even if the basic principles of redistribution are accepted, there is a manifest drawback. Incentives for behaviour which at individual level is good for the macro economy are impaired, for the simple reason that good behaviour is not rewarded and bad behaviour goes unpunished. The further equalisation goes, the less difference there will be between economically efficient and inefficient behaviour. It is our hypothesis that in large parts of the overripe welfare states of Europe the incentives for choosing behaviour that is good for growth are simply not big enough. This applies, not least, to Sweden.

There can also be a problem inherent in large parts of production in several European countries taking place in non-competitive sectors. Lack of dynamic in the public sector is a problem which also contributes towards inefficient use of resources. Every year in the business sector, hosts of enterprises are started up. Many of them grow, others lose market shares and a very large number go bust. This form of dynamic is lacking in the public sector, where start-ups and bankruptcies are practically unknown.

4.4 The Americans work on the job, while the Europeans work at their leisure

Another reason sometimes given for the higher quantifiable material prosperity of the USA is that the American works more. According to this hypothesis, poor development in Europe is connected, not so much with bad economics as with Europeans themselves opting to work less. Viewed in this light, Europe's lower level of material prosperity results from its own choice to have more leisure. In order for the differences in work input to pose a real problem for comparisons of per capita GDP between the USA and Europe, at least two conditions have to be met.

We will now briefly examine those conditions.

It is true that most European countries have fewer hours worked in the market sector (out of the total number of hours worked) compared with the USA. Table 4:1 shows the so-called LS ratio (labour supply ratio) in a number of European countries and in the

USA. The LS ratio (labour supply ratio) relates the actual number of hours worked in the economy's regular employment sector to the number of hours which would be worked if all individuals of adult age (16-64) worked full time, apart from taking five weeks' holiday. A ratio of one means everybody working full time, which of course is unrealistic and undesirable. A ratio approaching zero means, in principle, nobody working at all.

Table 4:1. The LS ratio for 2000 in a number of European countries and in the USA.

	LS ratio		LS ratio
USA	0.74	Greece	0.58
UK	0.67	Spain	0.57
Switzerland	0.67	Netherlands	0.55
Sweden	0.66	Germany	0.53
Finland	0.63	France	0.53
Denmark	0.62	Belgium	0.51
Ireland	0.59	Italy	0.48

Source: Gidehag & Öhman (2002).

In these terms, then, the USA uses 74 per cent of its total labour potential as against, for example, 66 per cent in Sweden. The difference compared with many other European countries is greater still. Thus the average American works more in the regular employment sector.

It is a well-known fact that not all absence from work amounts to leisure. On top of paid, recorded work, we have unpaid work in the home, the extent of which is of course much harder to measure. Attempts are, however, made to do so by means of extensive inter-view and questionnaire surveys. For Sweden's part, one such study shows work in the total informal sector, comprising both moonlighting and work in the home, exceeds the work done in the market. Given the tax wedges described earlier, it is a reasonable guess that work in the home and moonlighting are a good deal more common in most European countries than in the USA. Stretching things a little, perhaps Americans work more at the things they specialise in than people in Europe, which of course is basically good for productivity and growth.

Are the relatively few hours worked in the market sector in most European countries due to personal choice and not a question of incentives? This is very hard to believe. For one thing, absence from work does not mean leisure and relaxation but probably a great deal of work in the home. Secondly, tax wedges in Europe are very high and the proceeds of work are low. It is in fact something of a cornerstone of economic theory that incentives are truly important: the whole of micro theory is based on this assumption. Why should this not apply to the choice of work input in Europe?

Needless to say, the above is pure guesswork, a sketch of conceivable cause of European backwardness. Nor is the thesis a very new one, but that does not make it any the less interesting. The expansion of the public sector into overripe welfare states in large parts of Europe is and remains the best guess as to why our continent cannot measure up to our neighbour in the west.

5. APPENDIX

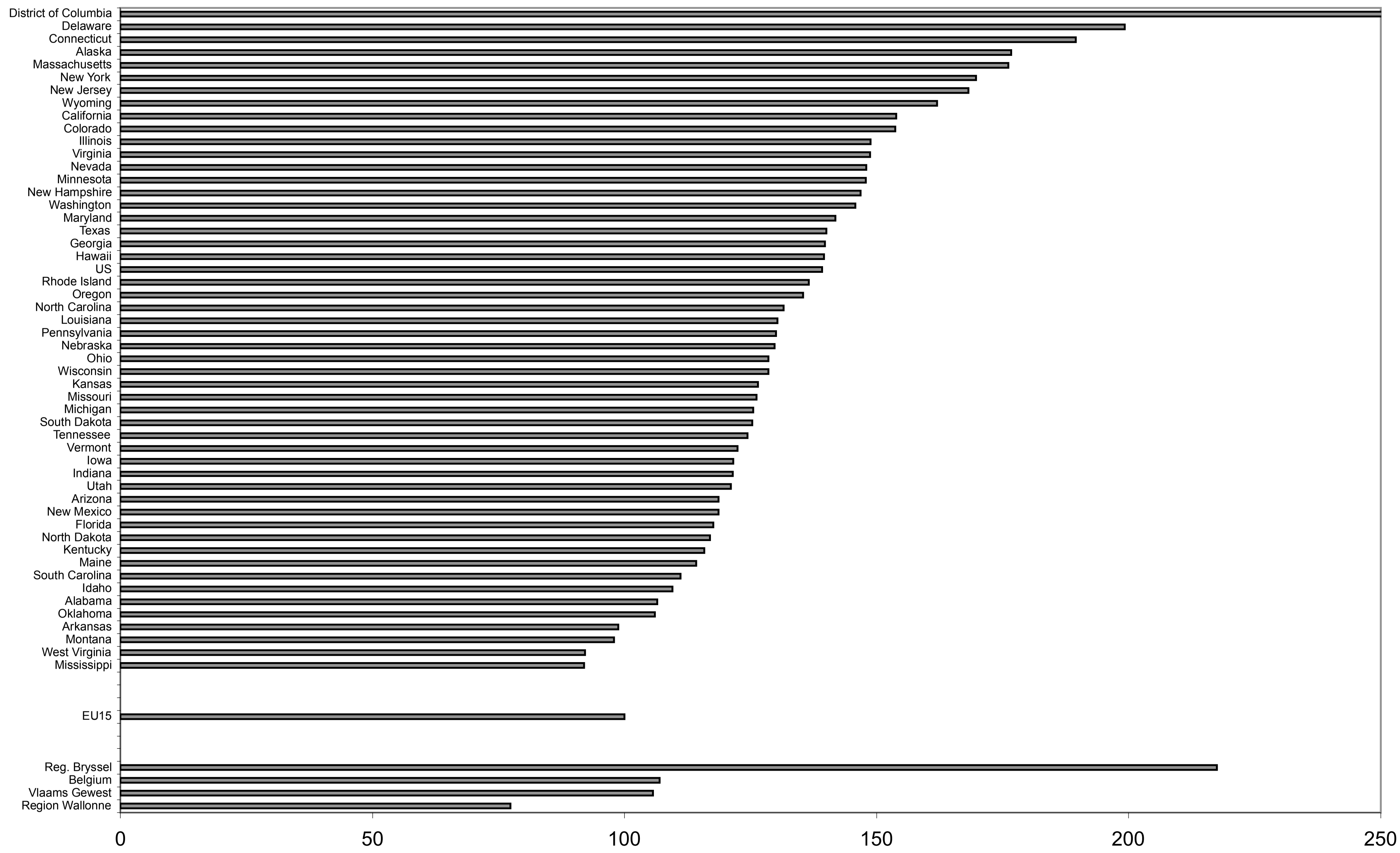
THIS APPENDIX GIVES SEVERAL EU COUNTRY'S per capita GDP in relation to states of the USA. The comparisons are expressed as an index, with EU 15 = 100. The index is PPP adjusted. The USA statistics come from the Bureau of Economic Analysis (see References). The EU are taken from Behrens (2004). Statistics in focus, General Statistics, Theme 1 – 1/2004.

These statistics can be downloaded from:

http://europa.eu.int/comm/eurostat/Public/datashop/print-product/EN?catalogue=Eurostat&product=KS-DN-04-001-N-EN&mode=download

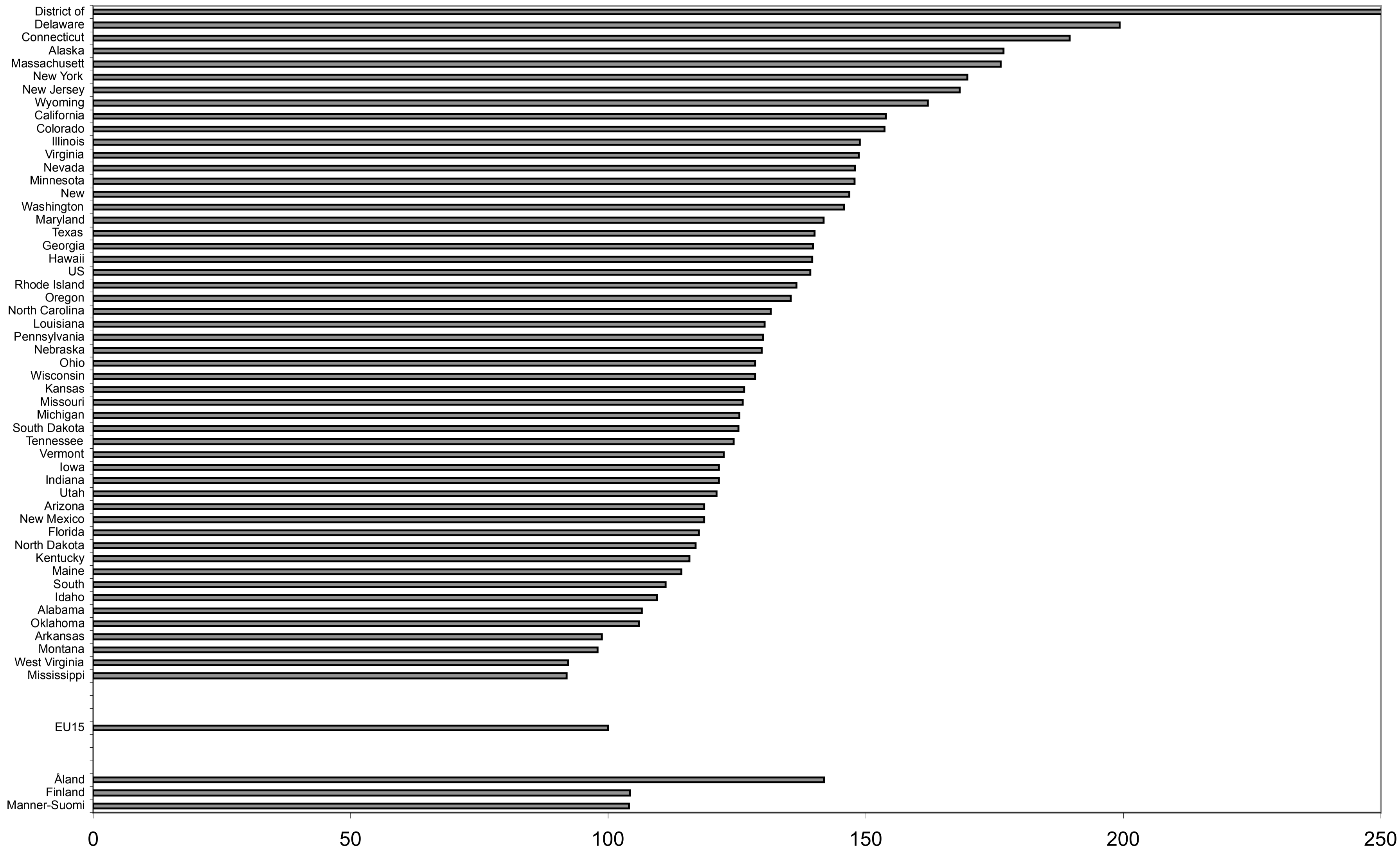
Belgium vs USA

If Belgium were an American state, it would be the sixth poorest in the Union. Only the Brussels region comes off well, with a per capita GDP some 50 per cent over the American average. Other regions have less per capita GDP than most of the poorest states of the USA.



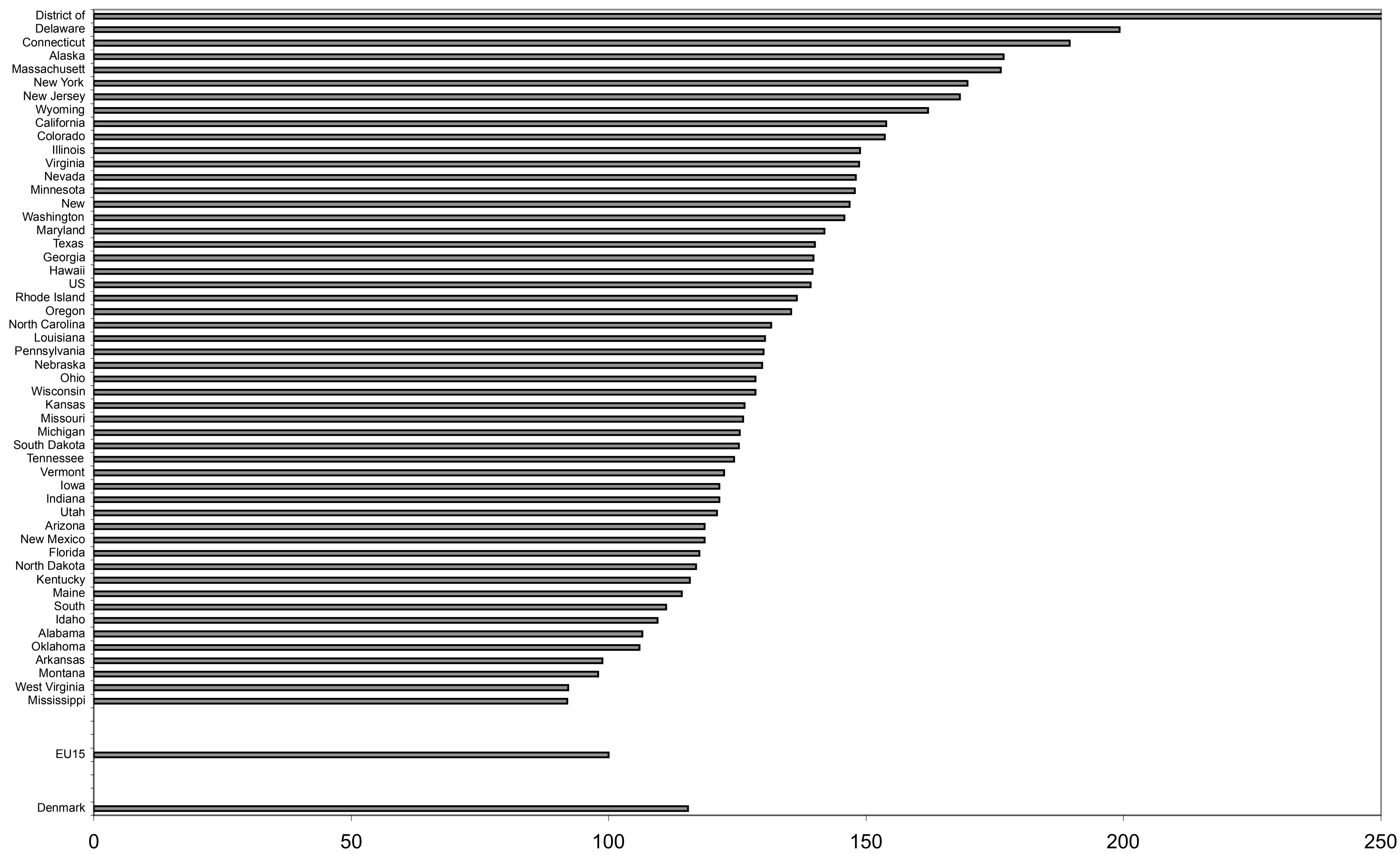
Finland

Finland would come fifth among the poorest if it were an American state.
The only region almost equalling the US average for per capita GDP is Åland.
Other regions have a per capita GDP below that of the poorest states of the USA.



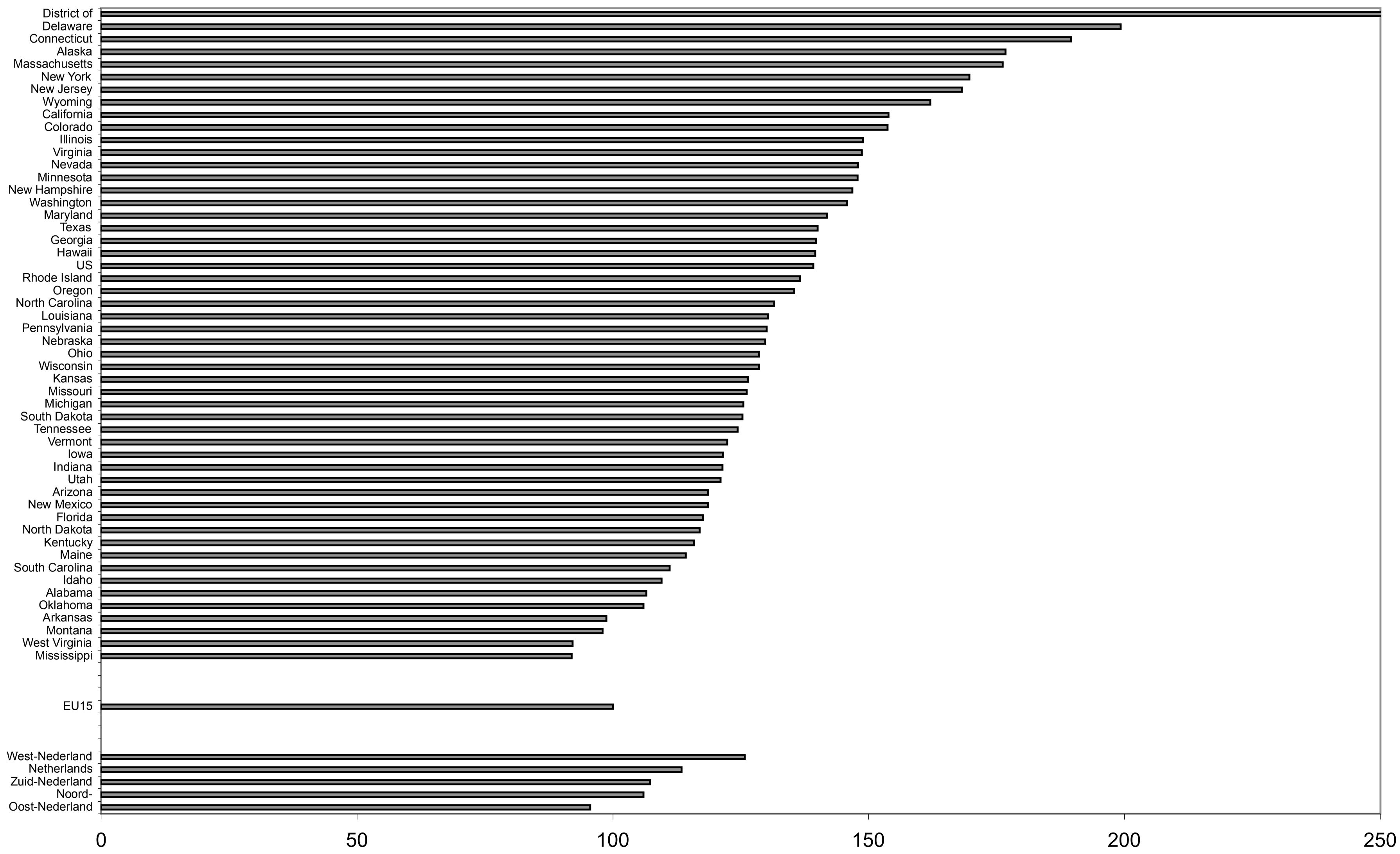
Denmark vs USA

Denmark, if it were one of the states of the USA, would come well below the American average for per capita GDP, ranking tenth among the poorest states.



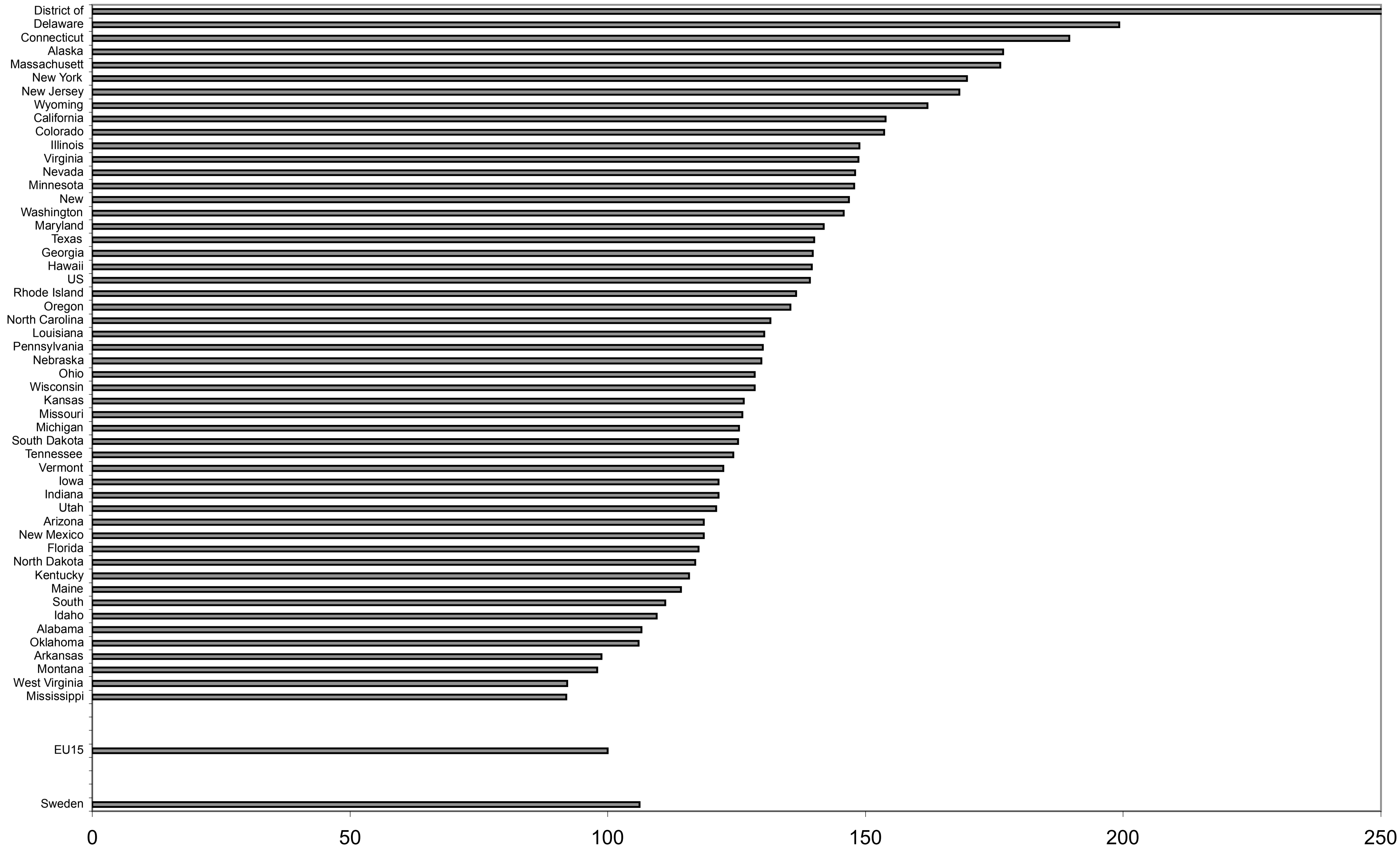
The Netherlands vs USA

The Netherlands as a state of the USA would come ninth among the poorest.
The West Netherlands come close to the US average for per capita GDP.
Otherwise all regions have a per capita GDP equalling those of the poorest states in the USA.



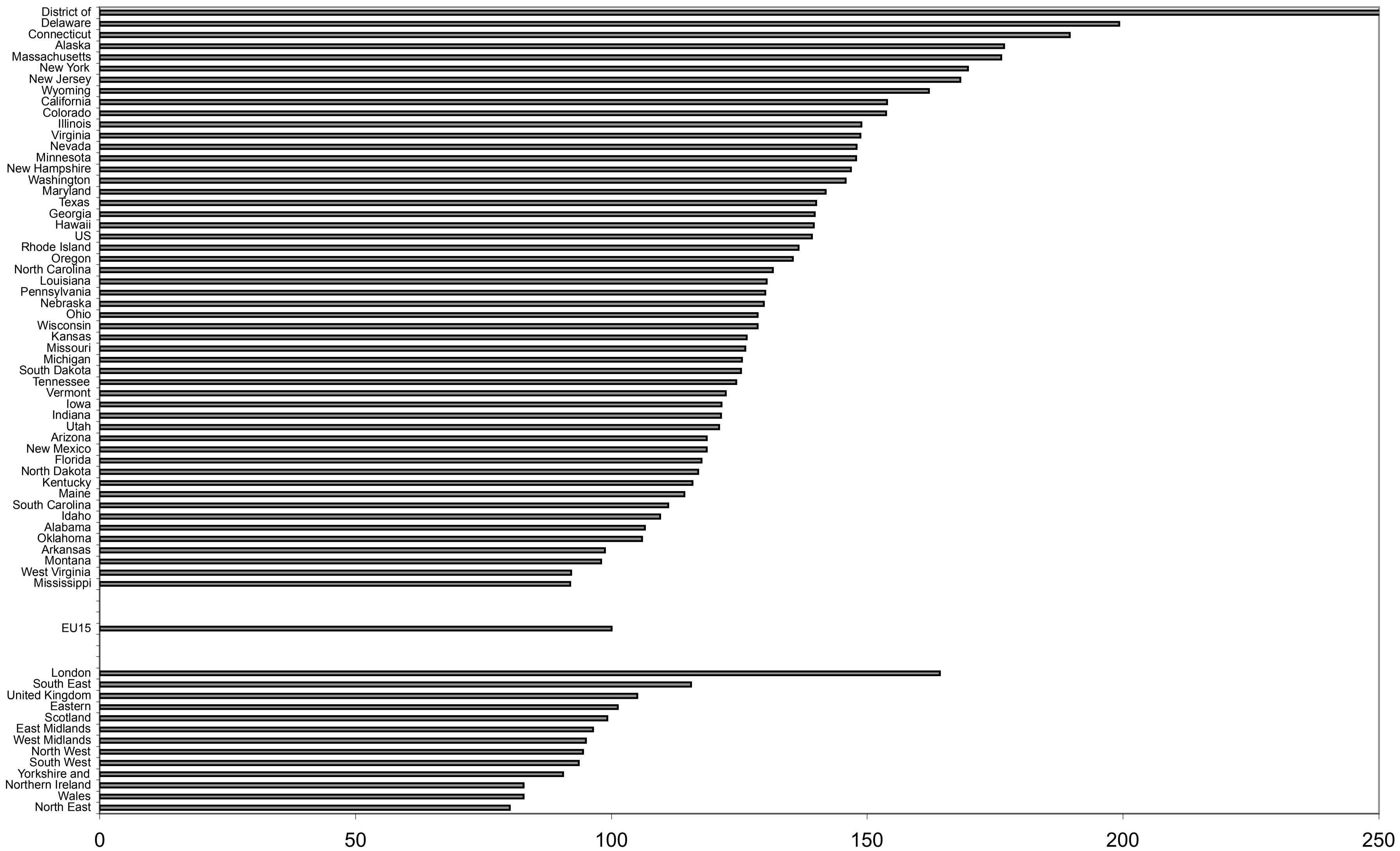
Sweden vs USA

Sweden as a whole would be seventh poorest as a state of the USA.
Even the Stockholm region falls short of the US average, and nearly all other regions have a per capita GDP below that of the very poorest state of the USA.



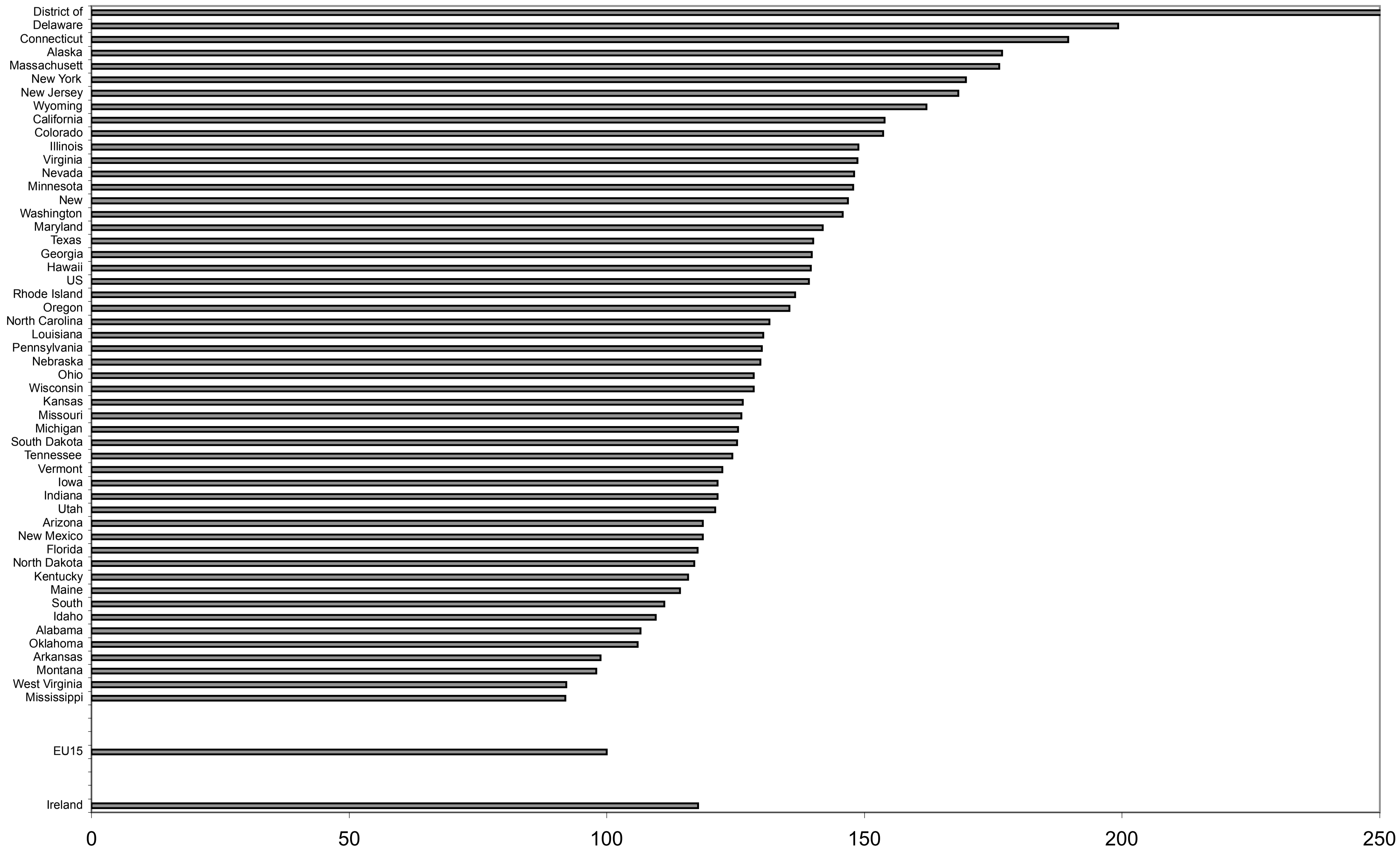
The UK vs USA

As an American state, the UK would come fifth among the poorest.
Only central London, with a per capita GDP some 18 per cent over the US average, comes off well in a comparison. All other regions, on the whole, have a per capita GDP approaching that of the poorest state in the USA.



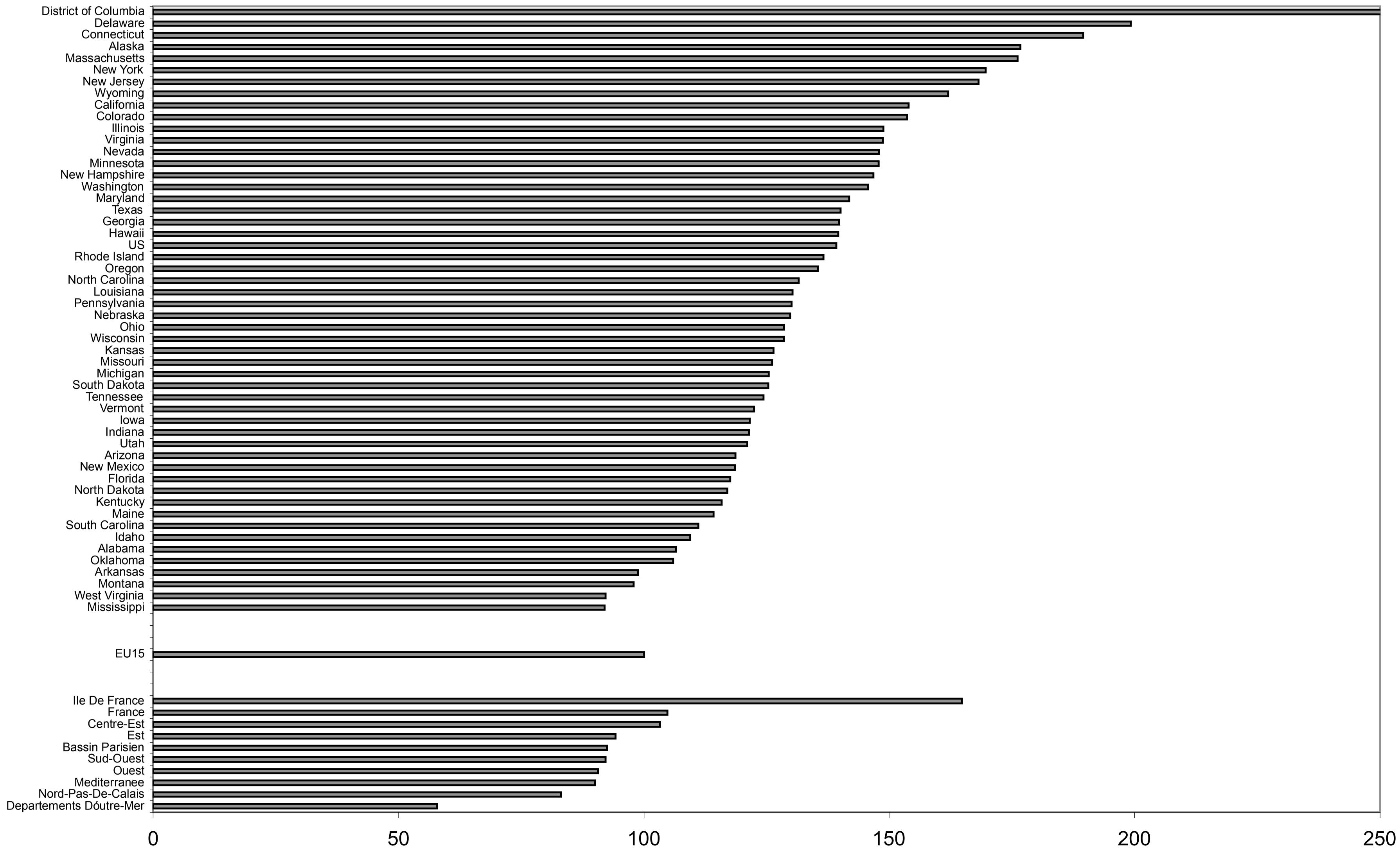
Ireland vs USA

Ireland, as an American state, would come twelfth among the poorest. The Southern and Eastern regions are slightly better off but their per capita GDP remains on a level with the poorest states of the USA.



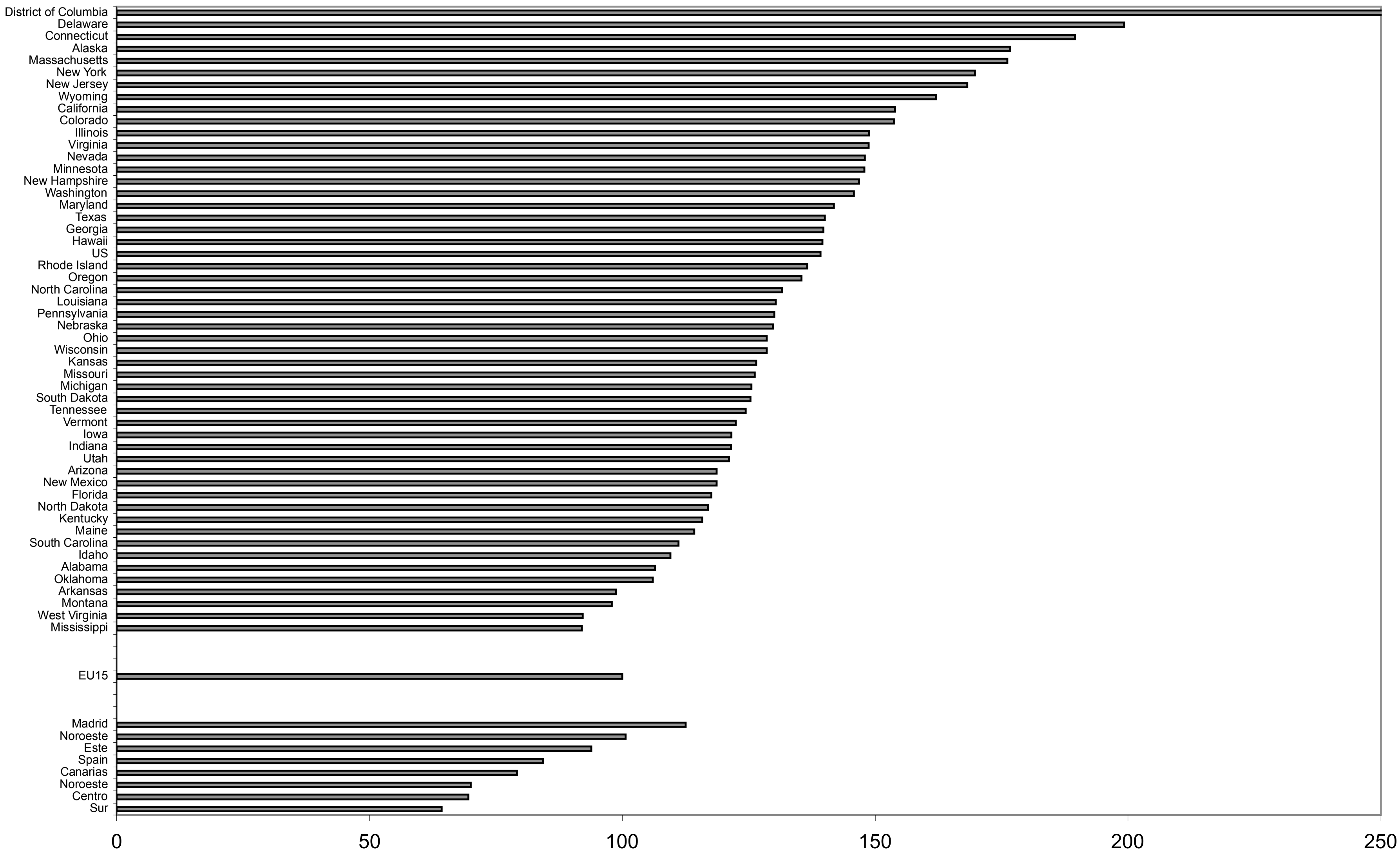
France vs USA

France as a state of the USA would be fifth poorest. Only the Île de France region exceeds by average US per capita GDP, by some 18 per cent. Otherwise all regions rank with the poorest states of the USA.



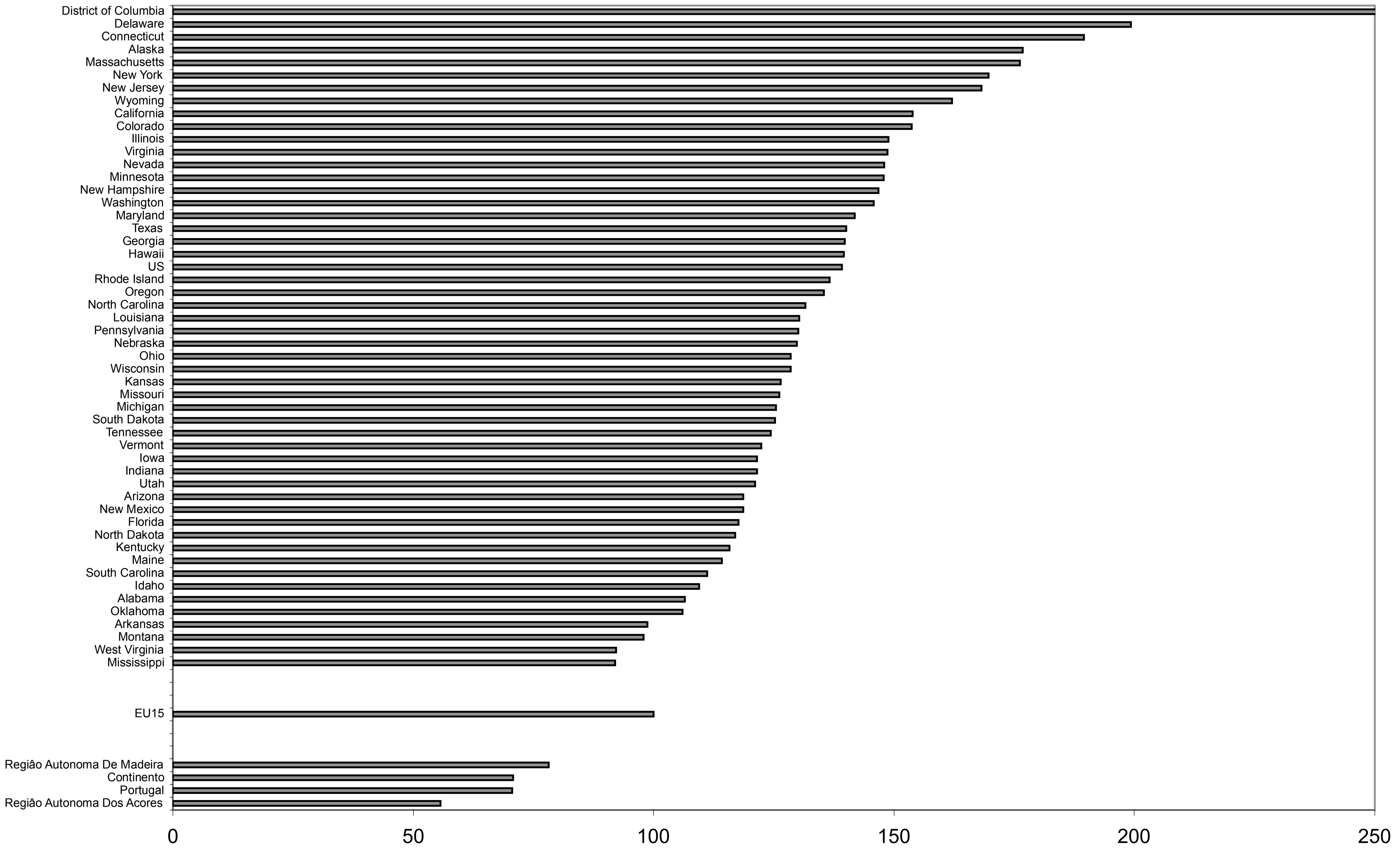
Spain vs USA

Spain would be one of the very poorest states of the USA.
Even the region surrounding the capital, Madrid (which has the highest per capita GDP) would be number nine among the poorest by comparison with average per capita GDP in the USA.



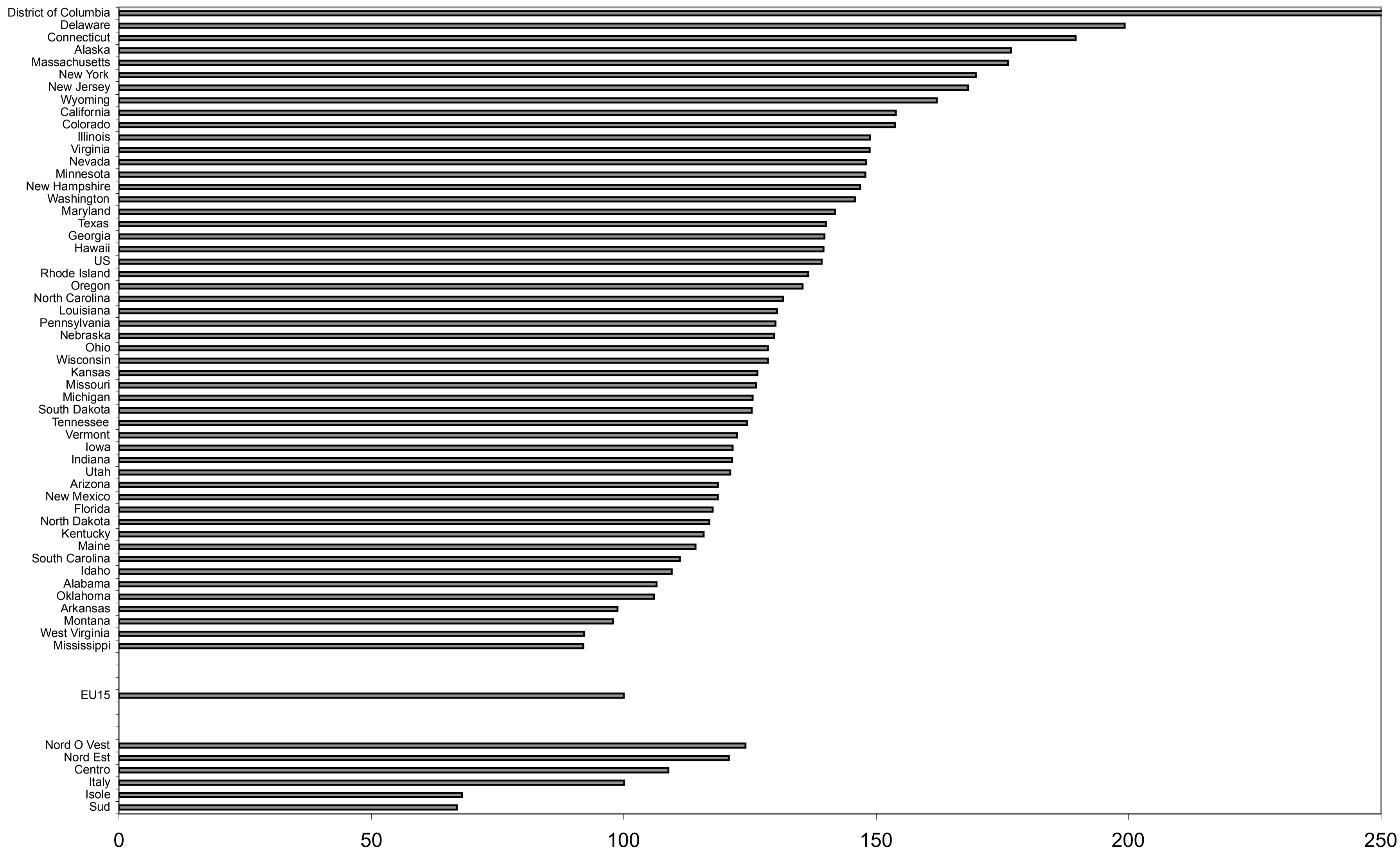
Portugal vs USA

Portugal as an American state would be one of the poorest.
All other regions, compared with the poorest states of the US, have less per capita GDP and would come far down on the list with Portugal as a state of the USA.

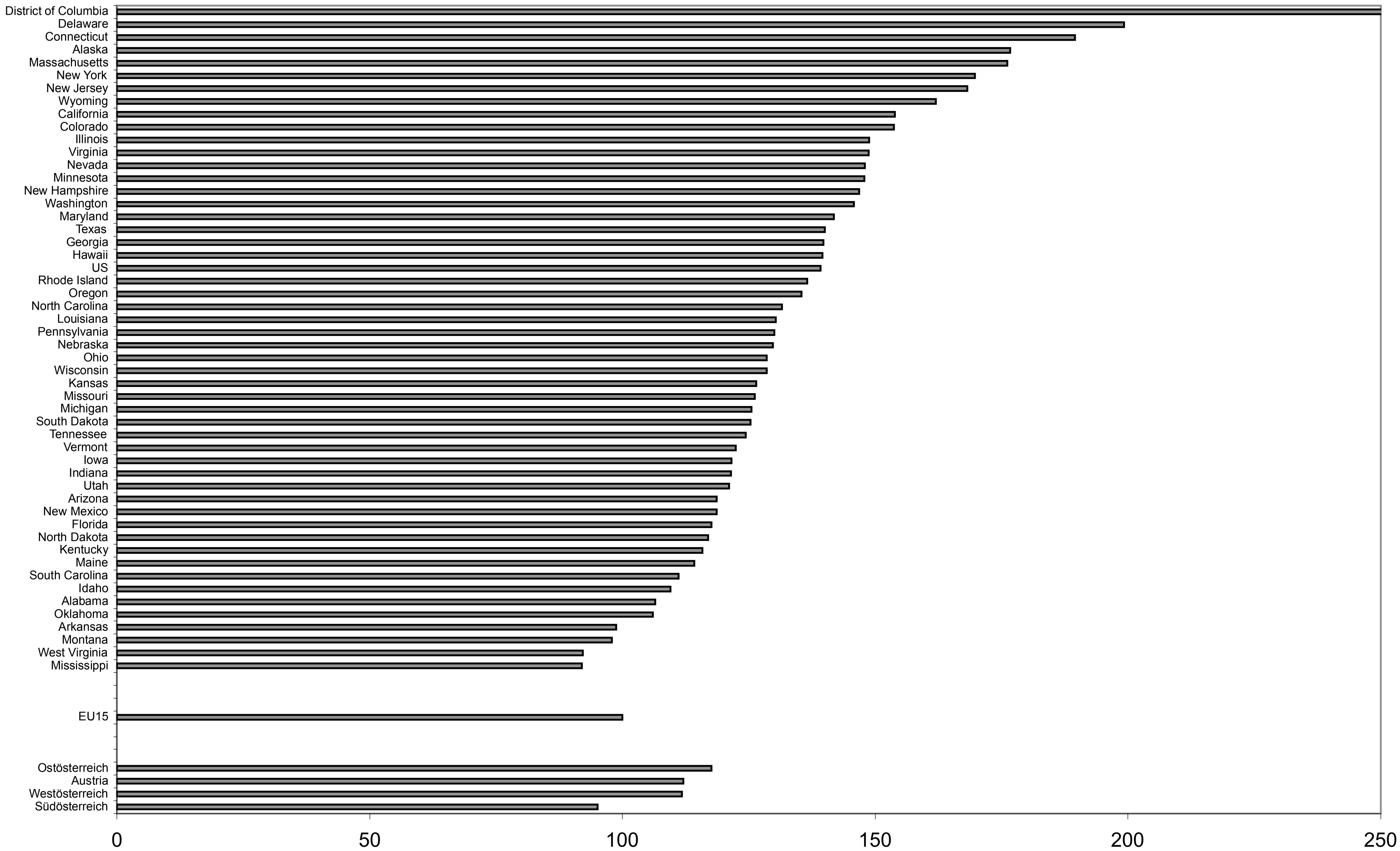


Italy vs USA

Italy as a state of the USA would come fifth among the country's poorest. In a couple of regions of northern Italy per capita GDP comes quite close to the American average, but otherwise most regions would, by comparison, come low down among the poorest states of the USA.

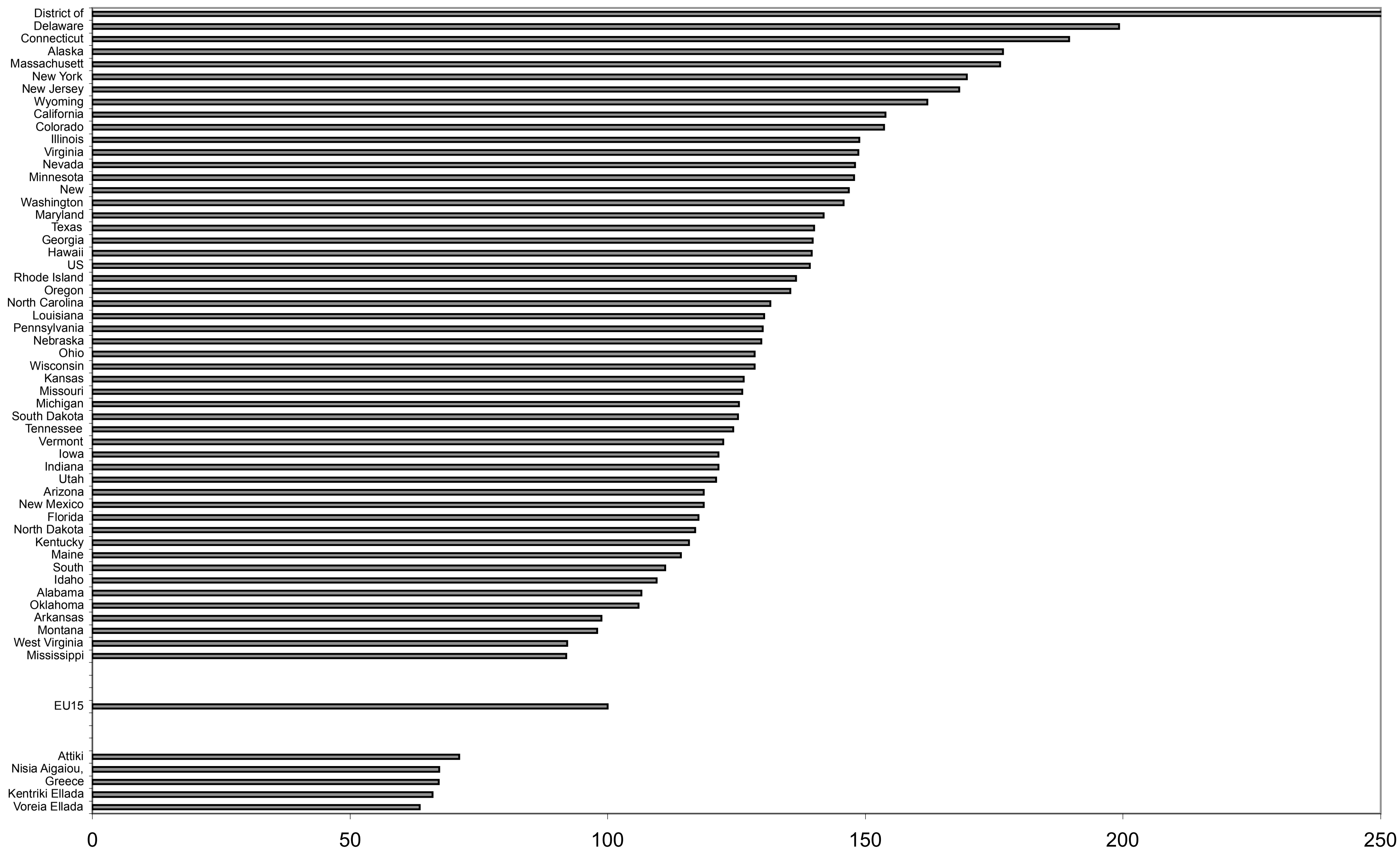


Austria vs USA



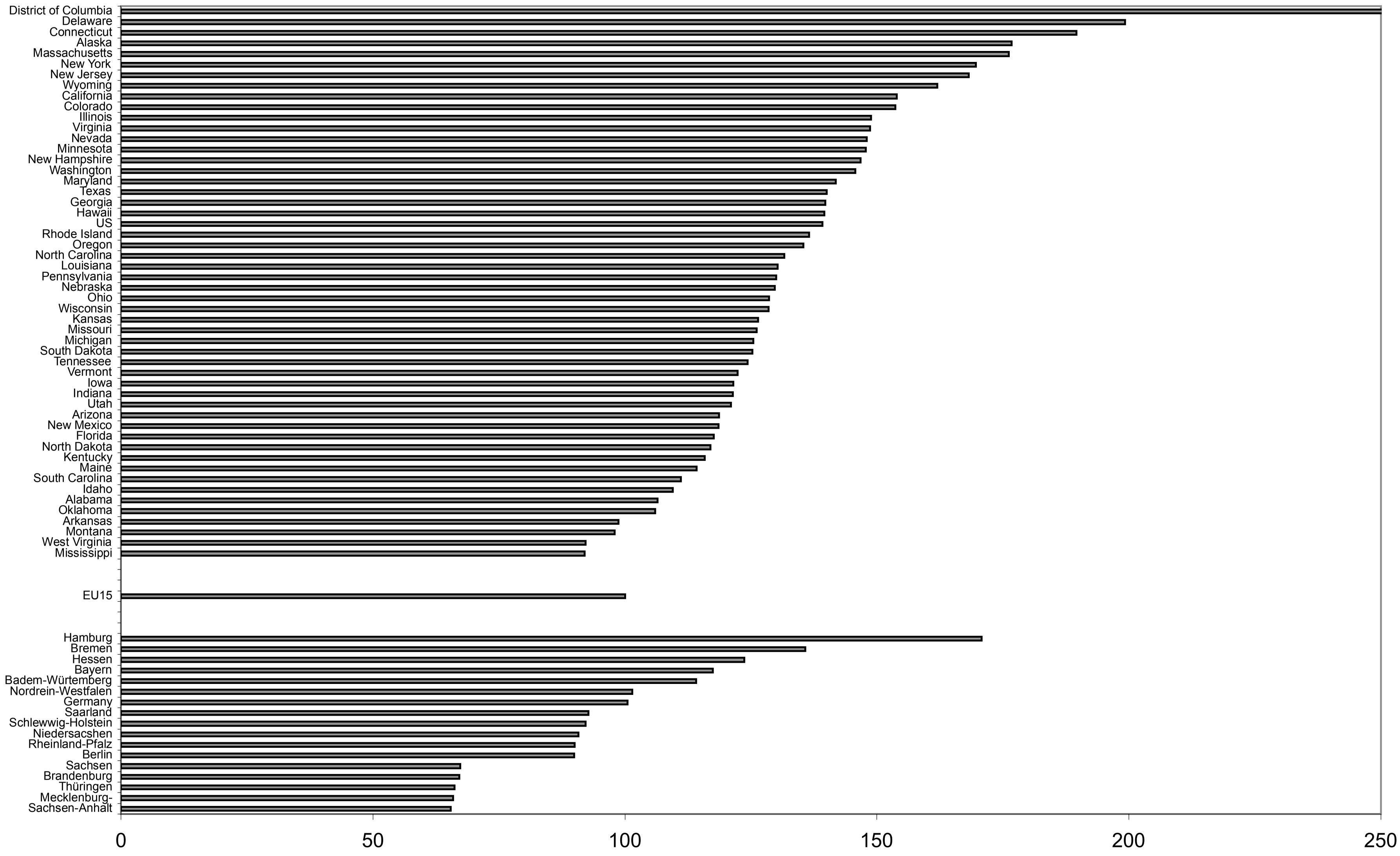
Greece vs USA

Greece has a per capita GDP which is less than half that of the USA, and as one of the states of the USA would come far behind the poorest of them today. The Attiki region has a slightly higher per capita GDP but still comes bottom.



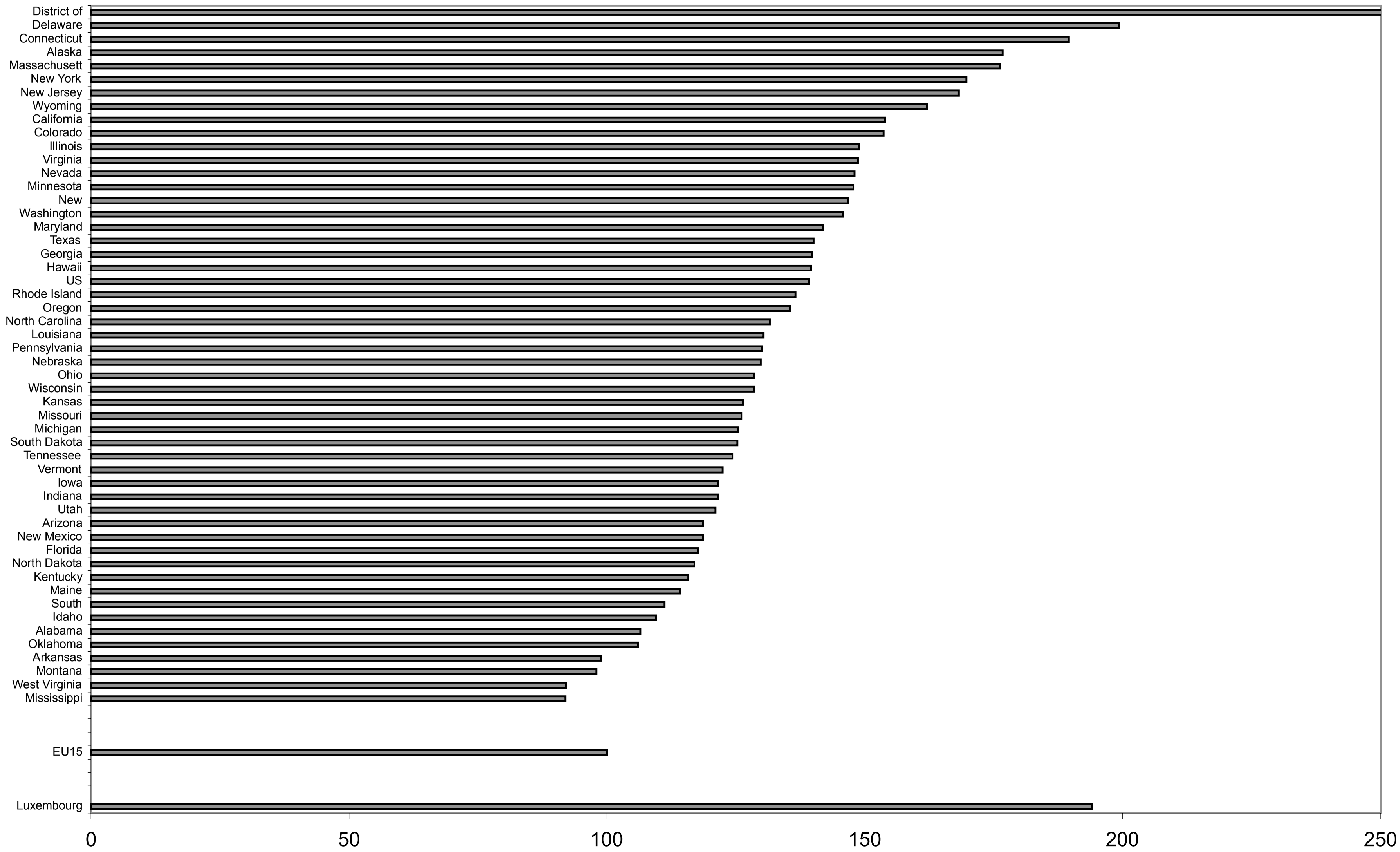
Germany vs USA

Germany would be the fifth poorest state of the USA. The Hamburg region comes off well, with a per capita GDP 23 per cent over the US average. Bremen too comes close to the US average, but per capita GDP in the other regions either equals or falls short of the poorest states of the USA.



Luxembourg vs USA

Luxembourg is one of the countries which can really vie with the USA in terms of per capita GDP. Luxembourg's per capita GDP is about 40 per cent greater that the USA's, and so as a state of the USA Luxembourg would not rank among the poorest.



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