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The economic ruin of Europe

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Assume the villain in a new James Bond movie has the goal of the economic destruction of Europe. How would he do it?

First some background. In the 1960s and 1970s, Europe boasted brisk economic growth. From 1965 to 1974, government spending in Western Europe averaged 37 percent of the gross domestic product (GDP), and economic growth averaged 4.3 percent yearly.

However, the European leftists gained power and increased government spending to an average of 47 percent of GDP by 1984, where it has remained, as compared to slightly more than 30 percent of GDP for the U.S. Not surprising, economic growth fell to an average annual rate of only 1.7 percent in Europe, while the U.S. enjoyed an average annual growth rate of 3.6 percent for 1984-2000. Also for the past 20 years, Europe has suffered an average unemployment rate more than 50 percent higher than the U.S.

During the 1950s, '60s, and '70s, the U.K. had a much lower rate of economic growth than Germany, France and Italy. By the time Margaret Thatcher took over in 1979 as prime minister, the U.K. was known as the "sick man of Europe." At that time, Britain had the most socialized economy in Europe and, as would be expected, the worst economic performance. Mrs. Thatcher undertook a massive program to privatize the economy and reduced taxes and spending.

Since the time of the Thatcher revolution, Britain has had the best economic performance of the four big countries in the European Union (i.e., Germany, France, Italy and the U.K.), but has not done as well as some of the smaller countries, like Ireland, which even more drastically cut tax rates.

In the 1990s, the EU decided to go to a common currency, the Euro. The Germans, who traditionally had the most responsible monetary policies because of their great fear of inflation, were concerned that the other countries might try to solve their fiscal irresponsibility through inflating the new currency.

Thus the Germans insisted on very rigid rules regarding the size of deficits any country in the EU was allowed to incur. At the time, it seemed like a wise thing to do. However, two fundamental errors were made in setting the deficit targets. The first error was the failure to distinguish between the two theoretical ways of reducing the deficits — cutting spending or increasing taxes.

A cut in government spending increases economic growth because less productive government spending is replaced by more productive private sector investing and spending. A tax increase reduces economic growth, thus making it harder to reduce spending and achieve revenue targets from lower levels of economic activity.

The second error in using the deficit target was equating deficits with inflation. In fact, there is little relationship between deficits and inflation. For instance, Japan has been running massive deficits for more than a decade, yet its problem is deflation not inflation. Lower tax rates on labor and capital (which increase economic growth), coupled with government spending restraint, have proven to be the only way for governments to reduce deficits.

The Germans and the French have just been ordered to reduce their deficits to meet the EU rules. The French announced they were going ahead with some tax cuts that will be growth enhancing but will not make appreciable

cuts in spending, which will diminish growth. The Germans have said they are going to increase some taxes, but make few changes in spending.

The German economy is barely growing (less than 1 percent for the past year), and these new fiscal measures are likely to put it into a recession, which will only increase deficits.

The danger for Europe is that the Germans may enter a deflationary spiral, like Japan, and drag the rest of Europe down with them. This is how it might happen: As the German economy gets weaker, the assets the banks hold become less valuable (stocks and real estate) which endangers the banking system and causes the banks to reduce lending, which further restricts the economy, causing prices of assets to fall further. Because the Germans are no longer in control of the central bank, they cannot produce additional money to offset the asset deflation.

As the Germans become less wealthy, they will buy less from their neighboring Europeans, who are highly dependent on the Germans.

For years, capital has flown out of the major European countries because of high taxes. This capital has gone to EU countries that have been more capital friendly, such as Luxembourg, Austria, Ireland, etc. and to non-EU countries like Switzerland and the U.S.

Again, last week the EU made another destructive decision, by insisting on information-sharing among the EU countries as to who holds this flight capital, and requiring those countries like Austria, Luxembourg and Belgium that refuse to share information to put a withholding tax on earnings from capital of up to 35 percent.

This requirement is not going to curtail tax evasion. It will merely drive more needed capital out of the EU to places like Hong Kong, where it will be neither reported nor taxed.

An additional irony of this situation is that many of the Democrats, who are accusing the Bush administration of economic mismanagement, are recommending exactly the same policies that put Europe into such a mess.

They argue for more taxes on capital rather than less. They argue for more government spending. Last week alone, the Senate Democrats proposed amendments to the spending bills that would have increased government share of spending by an additional 3.5 percent of GDP. Yet, these same Democrats decry the slow growth of the U.S. economy (3.1 percent this past year, which is in line with our historical average) while recommending policies that would give us a European-type growth rate that was one-fourth the U.S. growth rate last year.

The economically destructive villain is alive and lives in the hearts and minds of all of those who still believe socialism and statism solve problems rather than create misery. Eliminating this statist villain may be too tough even for James Bond, so the rest of us must try harder.

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