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**Lombard Street Research Ltd.**
30 Watling Street,
London, EC4M 9BR
Tel: 020 7382 5900
Fax: 020 7382 5999
e-mail: lsr@lombardstreetresearch.com
www.lombardstreetresearch.com

# 2003 to be good year for the world economy

## With world output 1 1/2% beneath trend, favourable macro outcomes ahead

**One of Friedman's key ideas generalised**

One of the most important ideas in macroeconomics stems from Friedman's celebrated 1967 presidential address to the American Economic Association. He argued that - when unemployment is beneath a "natural rate" where the demand for labour is in balance with the supply - inflation is not stable at a high figure, but accelerates without limit. In other words, the *change* in inflation (not the *level*) depends on the divergence of unemployment from equilibrium. This notion has been generalised to the proposition that "the change in inflation is a function of 'the output gap'", where the output gap is the difference between the trend and actual levels of output. So - if output is beneath its trend level - inflation falls and keeps on falling until above-trend growth takes output back to the trend level. Further, when the output gap is significantly negative, the prospect is for above-trend growth with low and stable inflation, or for trend growth with falling inflation. More concisely, the prospect is for favourable macroeconomic outcomes.

**OECD output well beneath the trend level implies favourable macroeconomic outcomes in 2003, and probably 2004 and 2005**

What were the last two occasions when the OECD area's output was well beneath trend? According to the June 2002 issue of the OECD's *Economic Outlook*, they were in 1984 when the output gap was negative by 2.1% and in 1993 when it was again negative by 2.1%. The events of the following few years demonstrated the broad validity of the theory. Above-trend growth was recorded from 1984 to 1987, and inflation started to rise only in 1988; and above-trend growth was recorded from 1993 to 1999, and inflation started to rise only in 2000. So what are estimates of the OECD's output gap today? According to *Economic Outlook*, the OECD area output gap this year will be negative by 1.5%. (Estimates independently prepared by Lombard Street Research's International Service and published in every month's *Global Leading Indicator* publication are much the same.) Moreover, inflation is at present much lower than in 1984 and somewhat lower than in 1993. Only one conclusion is possible. 2003, and (probably) 2004 and 2005, will be good years for the world economy.

**Policy will change by enough to deliver trend or above-trend growth**

After the horrors of the bear market, this may seem extravagantly optimistic. Above-trend growth of demand and output may appear implausible, even foolish, as analysts calculate the impact of sliding share prices on wealth and future spending. The key point is that no one in the main industrial nations wants falling prices. Policy - including, crucially, the short-term interest rates set by the central banks - will change by enough to ensure that 2003 and 2004 do see above-trend growth. As a result, the right way to think about the share price falls of the last two months is that they foreshadow another easing of monetary policy, not that they signal never-ending gloom for the world economy. There is a puzzle here, that economic activity has not recovered more meaningfully to a level of short-term interest rates which is already very low. (2002 has seen a recovery, and it has been spearheaded by interest-rate-sensitive areas such as housing and cars. It just has not been big enough.) The explanation may be that the binge of corporate borrowing in the late 1990s was so wild that it will take a long period of sobriety before balance sheets return to health.

**Professor Tim Congdon** **7th August, 2002**

# Summary of paper on 'The modern European state in the early 21st century'

**Purpose of the paper**

The 2002 Budget signalled large increases in UK government spending, which imply that taxes - which were about 35% of GDP in the mid-1990s - will be rising towards 40% of GDP. The paper asks whether the tax levels associated with the modern European state will prove sustainable, given the coming demographic challenges.

## Main points

* **The modern European state has seen the ratio of tax to gross domestic product ("the tax ratio") stay in a band of between 40% and 60% for over 20 years. Before the 1970s there had been hardly any peacetime experience of tax burdens as heavy as this.**

* **The continuation of economic growth in the 1960s and 1970s - despite tax levels which were already high by historical standards - may have caused economists to become indifferent to the damage caused by high taxation.**

* **Recent statistical work by the OECD suggests that high taxes are harmful to the economy. In one exercise a 1% increase in the tax ratio is associated with a loss of output of 0.6% - 0.7% of GDP.**

* **An upper bound to the acceptable "tax ratio" must exist. In fact, no economy has had a tax ratio above 60% in peacetime.**

* **The adverse effects of a high tax ratio may not be identified by micro-economic studies working on local data in a short-run context. These effects may arise from distortions of career choice and workplace location, and the disincentive to be employed at all, and may take decades before they become apparent.**

* **On unchanged policies, demographic trends in the early 21st century will take Europe's tax ratios above 60%. If this aggravates the deterioration in Europe's economic growth performance (compared with, for example, the USA), the intellectual foundations of the modern European state will come under attack.**

This research paper was written by Professor Tim Congdon. A slightly different version will be published in *The Salisbury Review*.

# The modern European state in the early 21st century

## Can Europe's high-tax welfare states cope with the demographic challenge?

**Tax burden of over 40% of output unusual by historical standards**

The modern welfare state is an historical aberration. By the phrase "the modern welfare state" is to be understood the set of political arrangements by which governments raise taxes and spend over 40 per cent of their nations' output in order to provide social security and so-called "public services" (mostly health and education). This set of arrangements has existed in much of Europe for over a generation and in a milder form (in which tax and government spending were roughly equal to or exceeded 30 per cent of output) for over two generations. But before the middle of the 20th century very few nations had experience of a government role on this scale, except in wartime. Until the late 1940s an almost universal pattern had been for the state to restrict peacetime taxation to less than a quarter of national output. (1)

**Characteristic of modern Europe, not industrial world as a whole**

Indeed, the constitutional and institutional structures associated with tax of over 40 per cent of output could be seen as distinctively European, and "the modern welfare state" might be equated with "the modern European state". As some rich countries in other continents also have a large government sector, this may appear misleading. However, the political debate in these countries (notably in the USA, Canada, Australia and New Zealand) is more equivocal about the benefits of big government than is typical in Europe. Tax and government spending above 40 per cent – and sometimes exceeding half – of national output may be characterised as particularly "European". (Note that in the newly developing countries of Asia, Latin America and Africa it is also unusual for the government sector to represent 40 per cent or more of national output. This is true of members of the Organization of Economic Cooperation and Development from the three continents – such as Mexico and South Korea – as well as their poorer neighbours. (2))

**Modern European state regarded as a prime example of the "liberal democracies" identified by Fukuyama in *The End of History***

The modern European state is widely regarded as a success. The late 20th century was a period of economic prosperity, political stability and social harmony in Western Europe, as it was in the rest of the industrial world. Fukuyama has claimed that the model of liberal democracy is so convincing that it constitutes "the universal and homogenous state that appears at the end of history". Further, this sort of state can be seen – in Fukuyama's words – "as resting on the twin pillars of economics and recognition". In his view, it both endorses the individualistic pursuit of material well-being in the English-speaking Lockean tradition and fulfils citizens' need for mutual appreciation in a cohesive society according to the continental Hegelian ideal. (3) The central argument of this paper is more cautious. Indeed, if the modern European state with its heavy tax burden and obtrusive government is taken as the archetype of Fukuyama's "liberal democracy", its pretensions to being "the end of history" must be rejected. The modern European state is inefficient and may prove unsustainable when it has to cope with the challenges of the early 21st century. Some of the most serious challenges will come from Europe's changing demographics, which – ironically – Fukuyama has himself discussed in his book, *The Great Disruption.*

**For much of late 20th century high taxes viewed as having little deleterious effect on growth**

To repeat, the tax levels imposed in European welfare states both now and over the last 50 years are remarkably onerous by long-run historical standards. The question immediately arises, "if so, why did these 50 years see such spectacular prosperity?". The conjunction of heavy taxation and continuous growth seems to refute traditional concerns about the adverse effects of taxation on work effort, allocative efficiency and the level of savings. In the 1960s and 1970s numerous articles were published in professional economics journals denying a negative relationship between taxation and work effort, and indeed between taxation and economic progress more generally. Most economists accepted that the relationship between the ratio of tax to gross domestic product and the rate of economic growth was unclear and that such a relationship might not even exist.

**But attitudes are shifting, as growth in high-tax Europe slows**

More recently, views have changed, with an expanding body of empirical work demonstrating that high taxes have important disincentive effects and are relevant to understanding the relative economic performance of different nations. This work applies both on a large scale in comparisons of nations over periods of several decades, and on a small scale in the analysis of tax effects on individuals' and companies' motivation. On a large scale, there is an undoubted contrast between the high growth enjoyed by Europe's economies in the 1950s and 1960s, when taxes were typically under 35 per cent of national output, and the slower growth recorded since the early 1970s, when taxes have often been above 45 per cent of national output. Further, in the 1990s the relatively high taxation in Europe compared with the United States of America may have been one reason for the slower growth of both productivity and output.

**OECD study in 2001 finds big tax effects on output**

An important study of the effects of taxation on growth was published last year by the OECD. The study tried – among other things – to estimate by econometric methods the effect of the ratio of tax to output on the level of output, using a sample of nations in the period 1971 - 98. (4) The outcome depended on the specification adopted and provided no simple rule of thumb. (The effect of the tax ratio depended – for example - on whether the level of government spending was also an independent variable in the calculation.) But – no matter the specification – the higher the tax ratio, the lower the level of national output. In the most ambitious case, where the tax ratio was allowed to affect investment and, at a further remove, national output, a rise in the tax ratio of 1 per cent reduced national output by 0.6 - 0.7 per cent.

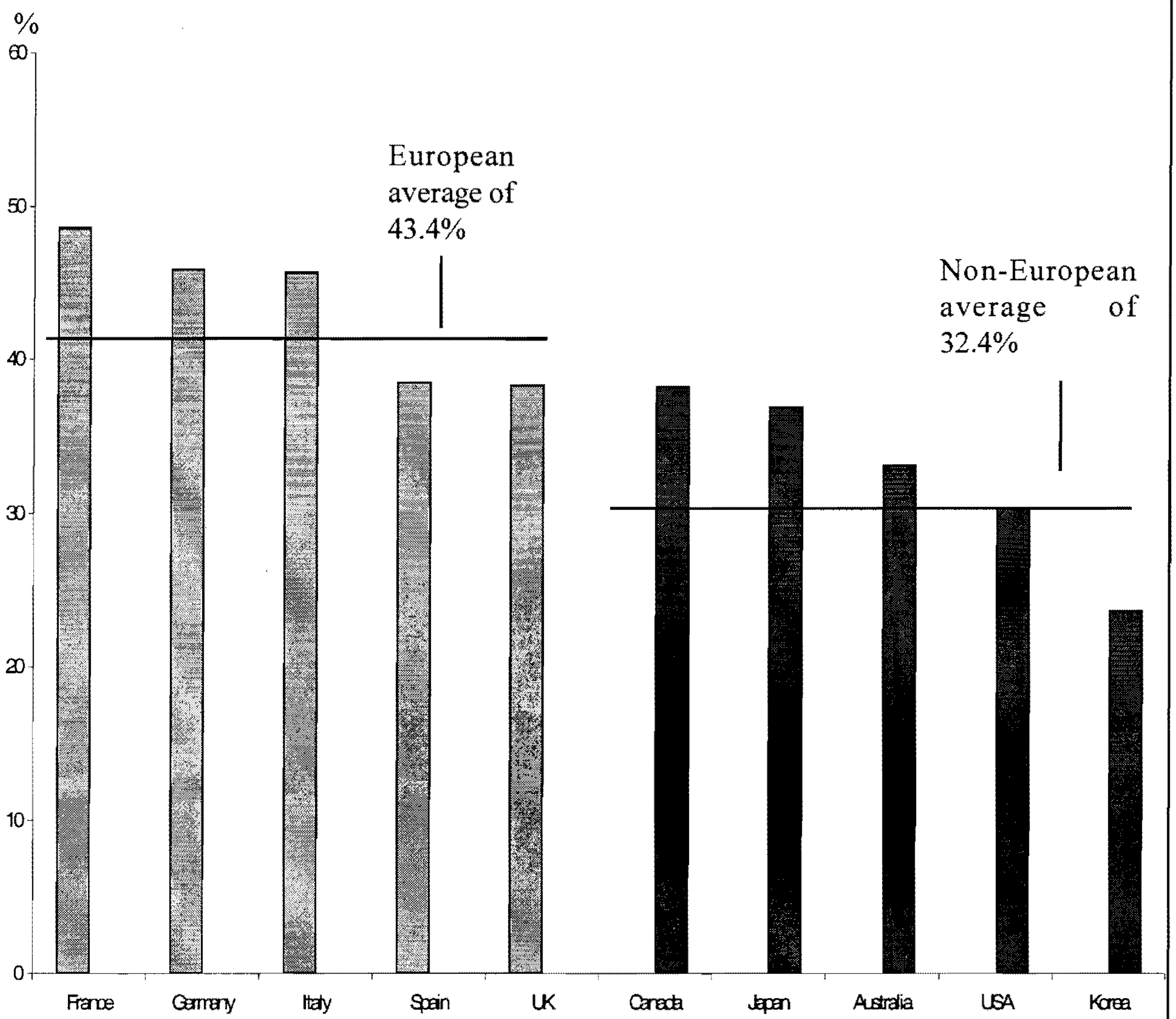
***A high-tax society could be losing output equal to the resource cost of the state's eduction and health provision***

This is a striking, even astonishing result. Taken at face value, it means that nations with a tax ratio of 52 per cent rather than 30 per cent are losing 15 per cent (almost a sixth) of national output because of the extra fiscal burden. The growth of government expenditure is often motivated by politicians' concerns about unsatisfactory provision of education and health services. As the supply of such services in the modern welfare state is predominantly in the state's hands, higher public spending and more tax canbe presented as essential if the services are to be improved. (The big increases in the British Government's health and education spending announced in the 2002 Budget were justified in these terms.) But health and education combined rarely

# Europe's large state sector

## Government spending 10% of GDP higher in Europe

Chart shows ratio of general government outlays to GDP, in %, in 2001. Source is June 2002 issue of OECD's *Economic Outlook*, Table 26




Five largest European OECD economies — Five largest non-European OECD economies

Source: OECD's *Economic Outlook*, June 2002

The chart shows that - as a rough rule of thumb - advanced industrial nations in Europe have a tax ratio about 10% higher than their counterparts in the rest of the world. This divergence has its orgins in an expansion of the welfare state in several European nations in the 1970s. In the 1950s and 1960s the tax ratio in Europe was similar to that in North America and Australasia. (Japan was an outlier, with exceptionally low levels of government spending relative to national output.) The differences between nations reflect demographics as well as contrasting attitudes towards social policy. People under the age of 20 and over the age of 65 pay little tax compared with the working-age group between 20 and 65. As a result, changes in the ratio of the working-age population to total population have a powerful effect on the tax ratio. At present Europe's demographics are favourable compared with North American, but this will change radically over the next 25 years.

take up more than a sixth of national output. *So the loss of output implied by extensive public sector provision and the associated high taxation is equal to the total level of resources required, in most nations, by the most conspicuous types of such provision.* There could hardly be a more damning demonstration of the inefficiency of the over-taxed and over-extended modern European state.

**High tax - particularly high payroll taxation - does appear to be affecting employment**

High taxation weakens incentives in many ways. Not only does it discourage hard work by those in employment, but also it affects career choice, influences the location of employment and deters people from being employed at all. In the 1950s and 1960s the tax ratio in Europe was similar to that in the USA, and so also was the proportion of the working-age population actually in work. Since the early 1970s the rise in taxation in Europe has been most obvious in the employment area. Payroll taxation, particularly on employers, has climbed sharply in order to meet extra social security costs. There is now a big difference between most European nations and the USA in the burden of payroll taxation; there is also a marked contrast in the proportion of working-age people who have a job. It is difficult not to believe that these two patterns are related. Smaller-scale studies of payroll taxation and employment generally confirm important incentive effects. Although they are far from uniform in reaching this conclusion, it would be remarkable if the price of labour has no impact on the equilibrium quantity of labour demanded by employers or supplied by workers. The conclusion has to be that the high taxation characteristic of the modern European state seriously undermines the efficiency of the labour market and so of the economy as a whole.

**Post-war European boom occurred because of power of stimulatory technological forces**

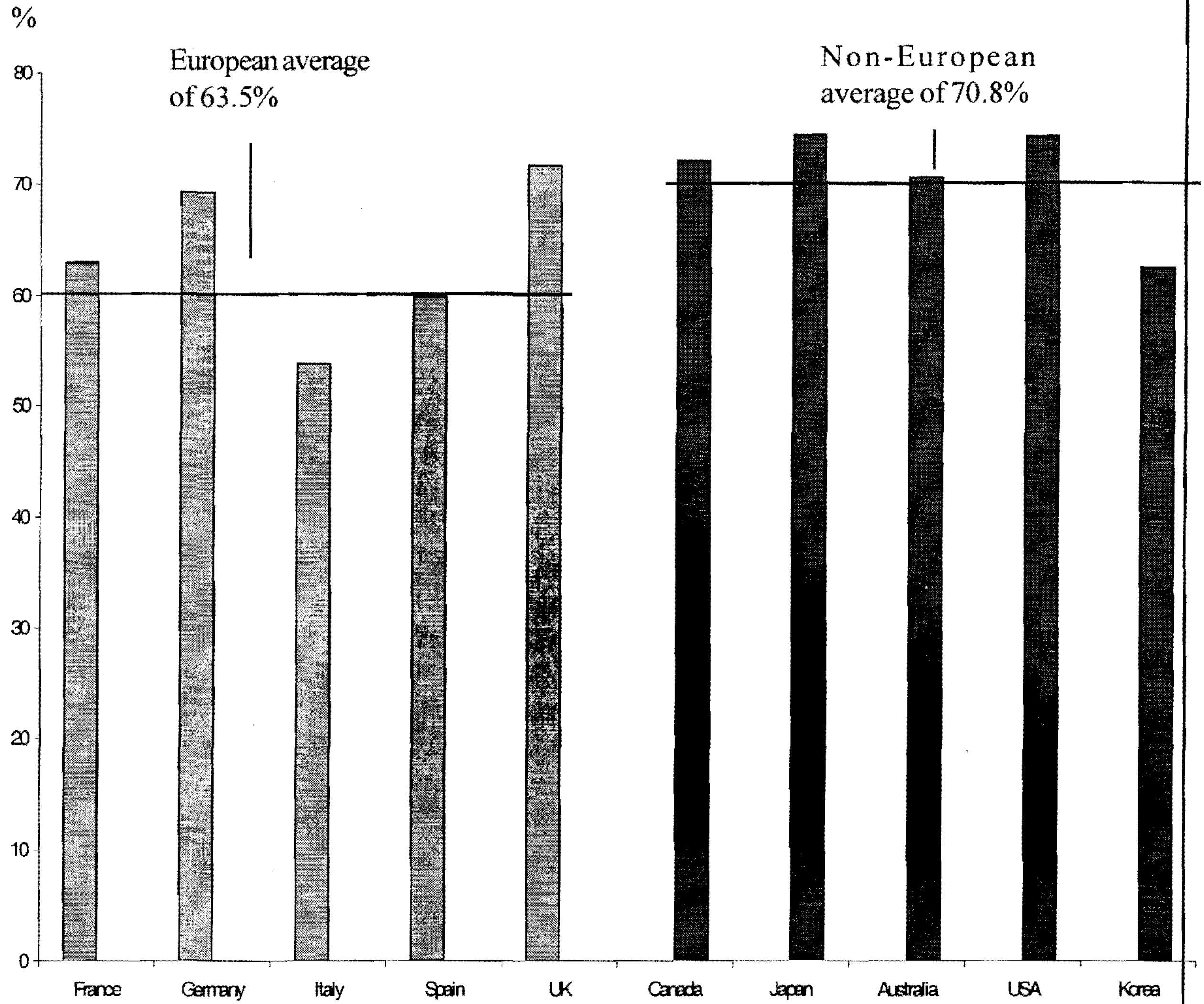
In retrospect, Europe's immediate post-war boom can be attributed to a combination of favourable influences so powerful that they swept aside the disincentive effects of high taxation. Europe's economies benefited from the reduction in trade barriers and increased economies of scale made possible by the post-war liberalisation of the world economy. Their ability to deliver high growth rates, which so impressed economists in the more slow-moving English-speaking nations, also stemmed from their relative backwardness in the late 1940s. A group of new technologies (the telephone, radio, manned flight, the combustion engine, the typewriter) emerged between 1870 and 1920. The USA had substantially exploited these new technologies commercially between 1920 and 1950, and in 1950 had levels of income per head which were two to four times those in Europe. Between 1950 and 1975 Europe copied the new technologies and raised its output over three times, and its living standards began to catch up with the USA's. The economic dynamism of Europe in the 1950s and 1960s did not show that the level of taxation was irrelevant to growth; it demonstrated instead the immensely benign effects of trade liberalisation and technological catch-up in the post-war international economy.

The combination of high growth and a moderately high tax burden in the 1960s deceived Europe's governments. It made them think that continued high growth was inevitable regardless of the level of taxes. In the early 1970s they projected high growth rates into the indefinite future and made their welfare systems more

# Does the tax burden affect employment?

## Fewer working-age people are in work in Europe

Chart shows "employment ratio" (ratio of employment to population of working age), as %. Source is June 2002 issue of OECD's *Economic Outlook*, Table 21.




Five largest European OECD economies　　Five largest non-European OECD economies

Source: OECD's *Economic Outlook*, June 2002

The damaging effect of high taxation on economic performance may develop over many years, possibly even over decades. A fair comment is that the most articulate fiscal pessimists of the immediate post-war years have been wrong. (For example, Professor Colin Clark's claims in 1945 that chronic inflation would emerge in societies where tax exceeded 25 per cent of net national product now seem much over-stated.) But the gap between the employment ratios in the main European OECD countries and those in the non-European OECD countries is striking. The main effect of high income and payroll taxes may be on whether people choose to have a job at all. The work/leisure trade-off is, of course, very different for people towards the end of their lives than for those at the start or in the middle. Logically, the impact of high taxes seems to have been greatest on people over the age of 50, where the employment ratios in OECD Europe are well below those in the rest of the OECD.

**and tempted Europe's governments to think that growth would be immune to high taxes**

generous than before, with – for example – significant increases in unemployment assistance and state pension benefits. Thereafter they were subject to what has been termed the "tyranny" of their own past commitments. The result was a steep rise in the ratio of social security transfers to GDP and an associated increase in tax burdens. According to Tanzi and Schuknecht in their study *Public Spending in the 20th Century: a Global Perspective*, "In the European Union social expenditure more than doubled between 1960 and 1980 as a share of GDP from 10 per cent to over 20 per cent, and continued to grow more slowly thereafter." (5)

**But Europe's performance was affected, with two points showing that tax mattered,**

**i. no state has had tax/GDP ratios above 60%, and**

In the 1980s Europe's economic performance remained satisfactory by its own past standards and relative to those of the USA. It was only in the 1990s that a rethink began. The existence of a prudent upper bound to the overall tax burden was implicit in two developments in these years. First, year after year several nations had tax ratios of over 40 per cent and a few had tax ratios above 50 per cent, but none had any long-term peacetime experience of a tax ratio above 60 per cent. In Sweden the ratio of public expenditure to GDP went above 60 per cent for a few years in the early 1990s, but the expenditure was covered by borrowing as well as taxes. The highest tax ratio for any OECD country in recent decades was, unsurprisingly, in Sweden. It occurred in 1989 when the figure was exactly 60.0 per cent.

**ii. uniformity of cuts in top tax raties symptomatic of concern about "brain drain"**

Secondly, large cuts in top rates of taxation (notably the top rate of income tax) were announced in many industrial countries even as public expenditure absorbed an increasing share of GDP. Plainly, governments had become worried about the damage that high rates of personal income tax might do to senior management incentives. They were particularly vulnerable to corporate decisions to shift headquarters operations, with all their expertise and highly-paid staff (and indeed their politically valuable tax payments), to low-tax jurisdictions. (Sweden's large companies – notably Ericsson – routinely warn their government that they will move their headquarters unless taxes are kept down to an acceptable figure.)

**Modern European state - with tax between 40% and 60% of GDP - is economically inefficient**

In short, the modern European state is not only an historical aberration; it is also an inefficient historical aberration. There is persuasive evidence that a tax ratio above 60 per cent is unacceptable. (There are no nations where tax has exceeded 60 per cent of GDP in peacetime.) Given this 60 per cent barrier, it would require a remarkably implausible discontinuity in the effort-reward relationship for a tax ratio of 50 per cent not to be more harmful than one of 40 per cent and for a tax ratio of 40 per cent not to be more harmful than one of 30 per cent. As Lord Robbins pointed out, can people who claim that a tax rate of 83 per cent has no effect on behaviour say the same about a tax rate of 100 per cent?

**Turner's defence of the modern European state**

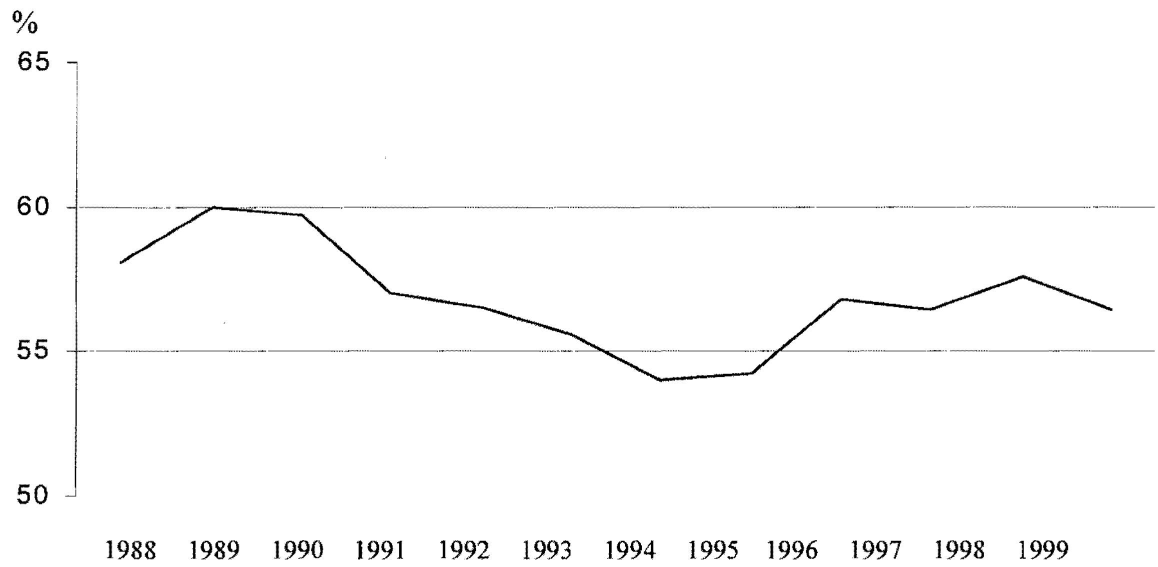
In his book *Just Capital: the Liberal Economy* Adair Turner, the former Director-General of the Confederation of British Industry, defended the tax burden found in most of Europe today. He made the well-known objection that taxes have two effects on behaviour, the "substitution effect" and the "income effect". The substitution effect refers to the impact of tax on the relative attractions of work and leisure, assuming income is unchanged. There is no doubt that the higher are taxes, the less

# Sweden's tax strains

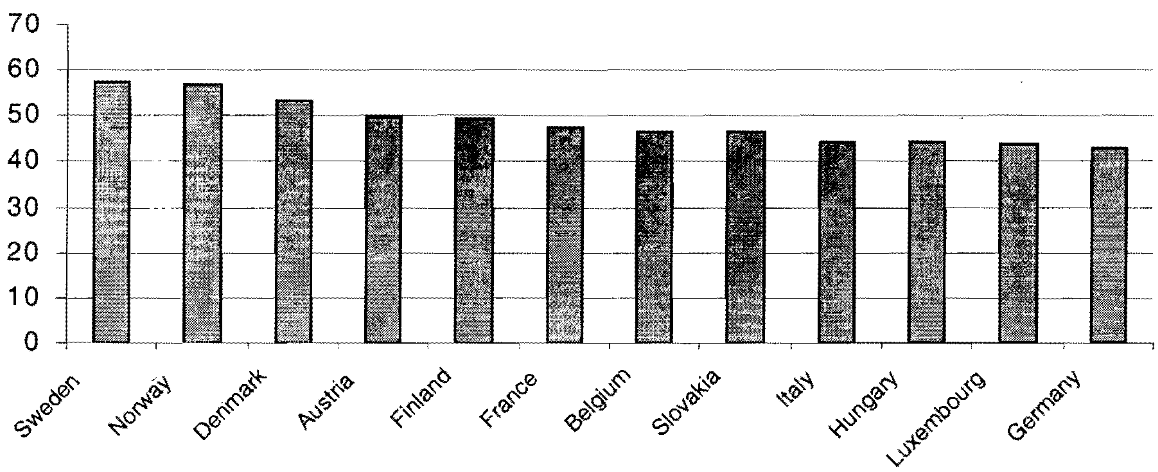
## Tax *never* above 60% of GDP in peacetime

Top chart shows that tax has not exceeded 60% of GDP in Sweden; bottom chart shows that Sweden has highest ratio of tax to GDP of any industrial economy.

1. Tax/GDP ratio in Sweden, 1988-99




2. Highest twelve tax/GDP ratios in OECD in 2001




Sweden's has long had a reputation for high taxes, but in fact its tax burden in the 1950s was not out of line with the rest of the industrial world. It was only in the 1960s and 1970s that the expansion of the welfare state took the tax ratio above 40% and, from 1975, above 50%. In the early 1990s Sweden appeared to face a daunting fiscal crisis, with the budget deficit exceeding 10% of GDP. But the ratio of government outlays to GDP was cut from 67.5% in 1993 to 52.2% in 2000, and the budget has recently been in surplus. Although Sweden tops the league tables for tax, its three Scandinavian neighbours - Norway, Denmark and Finland - also have heavy tax burdens. The ability of these economies to sustain very high tax ratios over long periods appears to cast doubt on the importance of the adverse effects of taxes on incentives. On the other hand, they have all drastically cut (by 10% - 15% of GDP) the ratio of government spending to GDP from peaks in the early 1990s.

attractive is work. According to the substitution effect, the response to higher taxes is therefore unambiguously negative. By contrast, the income effect emphasizes that an increase in taxes lowers post-tax income. People may react to this drop by working less or by working more. If they react by working more (because, for example, they have a fairly stable target standard of living) the income effect to a tax rise is positive. Further, if a positive income effect outweighs a negative substitution effect, an increase in taxes might be accompanied by extra work effort! This possibility – which, although paradoxical and surprising, could be found in the real world – heartens advocates of the big state and high taxes.

**Empirical work on supply effects of tax may be too short-term and small-scale in focus**

Turner cited a number of empirical studies on this question and summarized the results as showing a generally "rather small" negative effect of tax on work effort. (6) However, the body of empirical work under review begs as many questions as it answers. All the studies suffer from the short-term and limited context in which they are set. Once people are in a particular job, differences in the tax rate may have only a modest impact on their hours of work and the intensity of their work input. But the proviso "once people are in a particular job" is crucial. Tax also affects whether they want to work at all, their selection of career and the location of their workplace. Over the last 15 years governments have reduced the top rate of income tax in nearly all industrial countries. The uniformity of the pattern suggests that governments have learned that there is a maximum sensible top rate of income tax, which is – almost certainly - under 50 per cent.

**Damage from high taxes may take decades to emerge**

If high taxes do their damage by discouraging employment, by dissuading people from choosing high-productivity, high-income careers and by provoking the emigration of talented people, their effects are likely to take decades to be felt. As a tax ratio of over 40 per cent has prevailed now in the EU since 1975, it may have been one reason for the slowdown in economic growth since the 1970s. In *Public Spending in the 20th Century* Tanzi and Schuknecht note that economic growth slowed across the industrial world from about 4 per cent a year in the 1960s to around 2.5 per cent in the 1986 – 1994 period. But they continue, "[t]he decline in economic growth has been most pronounced…in countries with big governments where growth rates fell from 4.1 per cent to only 2 per cent." (7) The countries with big government are those where public spending exceeds 50 per cent of GDP. They are all in Europe.

**Threat to prosperity to be aggravated by demographic challenges of early 21st century**

The unwise promises on pension and social security made by Europe's governments in the early 1970s may have begun to reduce employment by the late 1970s and 1980s, but output growth continued. It was only in the 1990s that serious concern was expressed about the sustainability of welfare commitments. In the early decades of the 21st century high-spending European governments will face challenges of even greater severity, with demographic developments being of particular importance. Over the next few decades the number of people of working age will start falling across Europe. From 2010 the typical annual rate of decline will be 1 per cent a year, but – according to the World Bank - in some countries in some five-year periods it will be almost 2 per cent. (8) It is this demographic prospect which threatens the sustainability of the modern European state.

# European catch-up is over

## US productivity growth may have overtaken European

Chart shows five-year moving average of productivity growth, % per annum. Sources are various OECD publications. Years before 1985 data are for real GDP per person employed, for 1985 and after they are for productivity in the business sector.


According to Maddison (in his *The World Economy: a Millenial Perspective*) GDP per capita in the 12 largest European economies in 1950 was $5,013 (in 1990 dollars) compared with $9,561 in the USA. (In fact, GDP per capita in the USA was virtually three times that in Germany and Italy, and four times that in Spain.) Europe therefore enjoyed huge scope for catch-up growth. Its productivity growth in the 1950s and 1960s was indeed typically far ahead of the USA's, and a smaller but still favourable gap persisted into the 1970s and 1980s. But - according to Maddison - the ratio of European GDP per head to that in the USA peaked in 1991 at about three-quarters. His figures - broadly consistent with the message in the chart - show the USA moving ahead again since then. In other words, Europe failed to complete the catch-up in productivity and living standards that marked the first two post-war generations, and now appears to be falling behind.

**If economic growth were to stall, rising expenditure on health and pensions for the elderly would cut post-tax incomes from those in work**

A realistic conjecture is that economic growth and the accompanying rises in living standards are necessary to the political viability of the modern European state. People resist cuts in post-tax incomes from an unchanged work input, as there is a sense of injustice in getting less from the same amount of effort. (National emergencies – as in wartime – may provide an exception.) Over the next 40 or 50 years government spending will increase in real terms all over Western Europe, because of the welfare commitments that have already been made. In particular, rising numbers of old people will be entitled to extra pensions and can reasonably expect health care on the same cost basis per head as the elderly today. Unless national output increases, the taxes needed to finance the extra expenditure will erode the post-tax incomes of those in work. To repeat, economic growth is necessary to the political viability of the modern European state. In Daniel Bell's words, "Economic growth has become the secular religion of advancing industrial societies: the source of individual motivation, the basis of political solidarity, the ground for the mobilization of society for a common purpose." (9)

**And economic growth in Europe may stall**

The growth rate of national output is equal to the sum of the growth rates of productivity (output per person employed) and employment. Productivity growth has declined in Europe since the 1960s, with – for example – the members of the Euro-zone currency bloc recording increases in output per head of only 1 per cent a year in the six years to 2001. If employment were stable, productivity growth of only 1 per cent a year would imply growth of national output also of only 1 per cent a year. Unfortunately, from 2010 the decline in the population of working age – and probably in employment – would cancel the 1-per-cent-a-year productivity growth. Economic growth would come to an end.

**Risk of a downward spiral as the tax base is eroded**

How would Europe's societies cope with the disappearance of their key "source of individual motivation" and their "basis of political solidarity"? How, in particular, would the population of working age react to declines in post-tax income which reflect the interaction of stagnating total output and the increasing claims of elderly dependents? It is legitimate to speculate on the risk of a downward spiral of decline, in which high tax rates reduce the proportion of the working-age population actually in a job, the fall in employment cuts output and erodes the tax base, the erosion of the tax base has to be countered by a rise in tax rates, which reduces the proportion of the working-age population in a job, and so on. A downward spiral of this sort would obviously be unsustainable. The basic assumptions of the social and political arrangements responsible for it would have to be re-examined.

**Demographic pressures may take tax/GDP ratio above critical 60% level**

Much would depend on the ratio of tax to national output. At present the ratio of the dependent age groups (i.e., those of 19 and under, and of 60 and over) to people of working age in the European Union is about 80 per cent. By 2040 the ratio is expected to exceed 120 per cent. With government expenditure on pensions, health and education typically over a quarter of national output in Europe today, the rise in dependency implies additional expenditure and tax of about 15 per cent of national output. (Of course, the situation varies from country to country. It is much worse than the average in Italy and Germany.) As taxation is already in the range of 40 to 50 per cent of output today, the consequence would be tax-to-GDP ratios of over 60 per cent. But it has already been shown that no nation has previously had a tax to GDP ratio of over 60 per cent for an extended period in peacetime.

The demographic prospect in the early 21st century may undermine and eventually invalidate the modern European state. The average European woman stopped having two or more children in the mid-1970s; in the late 1990s she was typically having 1½ children. Plainly, if women have 1½ children (rather than the replacement level of two) for a generation, the number of people under the age of 25 at the end of that generation is about a quarter lower than at the end of the previous generation. A big fall in the number of people of working-age now seems unavoidable in the opening decades of the 21st century, with the accompanying danger of total economic stagnation. Even if women were now to be actively encouraged (perhaps by public policy) to have more children, their offspring would not immediately join the workforce. On the contrary, in a transitional period the costs of educating the young would increase and add to the taxes paid by the working-age population.

**Cuts in benefits to each dependent seem inevitable and have already been implemented by some governments**

One answer would be for Europe's citizens and politicians to restrict the size of the state. Given that the ratio of welfare recipients to the total population is certain to rise for demographic reasons, the obvious step would seem to be a deliberate reduction in the value of benefits to each recipient. This may sound unkind, but in fact several European nations have already lowered pension or other benefits in order to balance budgets without raising tax. They have done so without revolution or even particularly marked civil strife. For example, a pension reform package in 1995 went some way to curb the Italian state's long-term pension liabilities and has been followed by a decline in the ratio of government spending to GDP. The collapse of the modern European state is not inevitable. Tax may hover between 40 and 60 per cent of GDP decade after decade, as governments fend off the adverse fiscal consequences of demographic trends by piecemeal retrenchment and small-scale, tactical economies. Although pensioners may be worse off in 2020 or 2030 than their counterparts to day, they will not be destitute.

**Several Asian and Latin American states with lower tax ratios may achieve economic catch-up with Europe**

But – at best – the long-term outlook for the modern European state, with its extraordinarily high taxes and all-encompassing welfare spending, is unappealing. It is true that welfare cutbacks have so far proved politically acceptable, but that has been in association with continued, if slow, output growth. The difficult period will be in 2010s, 2020s and 2030s when the demographics become particularly hostile and output growth may cease. The threat to Europe's image of economic success and technological superiority may then be compounded by faster output growth and a catch-up of living standards in such nations as South Korea and Taiwan, and perhaps even Mexico and Chile. (All four of these nations have a lower ratio of tax to national output than the European average, as well as more modest social security systems and far greater reliance on private sector provision of health and education.) Even if the modern European state remains sustainable, its inefficiency may become so patent that the case for reform cannot be resisted.

**Fukuyama's "liberal democracies" could have tax ratios of 25% or 55%, or 10% or 60%, but which would give greater freedom and which would be more efficient?**

Fukuyama may be right that "liberal democracy" is the best form of government that can be devised. *The End of History* made a compelling argument that the free market and private ownership of assets are necessary for full economic maturity, and set out strong grounds for believing that advancing industrialization should produce liberal democracy. (10) But when Fukuyama claimed that, "[a]lmost all countries that have succeeded in achieving a high level of economic development have ... come to look increasingly similar to one another", he went too far. (11) He overlooked a basic feature – perhaps the most basic feature – that differentiates modern industrial societies. Is a "democracy" still liberal, does it still allow sufficiently extensive free choice, when tax exceeds 60 per cent of national output? Or is the ratio necessary to ensure the "liberalism" of a "liberal democracy" some lower figure? And, even if a democracy can be classified as economically liberal with a tax ratio of over 40 per cent, is such a democracy likely to be as economically efficient as one with a tax ratio of 10, 20 or 30 per cent?

**The modern European version of "liberal democracy" may not be *The End of History***

In chapter 12 of *The End of History* Fukuyama, invoking Hegel at length, remarked that, "if people living in liberal democracies express no radical discontent with their lives", then "[t]he historicist philosopher would be compelled to accept liberal democracy's own claims to superiority and finality". (12) But it is far from clear that people living in Europe's liberal democracies will continue to accept the economic outcomes of these societies. Locke and Hegel may not be so glibly reconciled; the English-speaking nations in the newer continents may keep the the state smaller, and taxes lower, than European nations with their different political traditions and philosophical legacies. If the demographic pressures of the next few decades curtail or even halt economic growth, if the stagnation of output is accompanied by intense strains in the distribution of national product and if the resulting conflicts are not successfully mediated by the political process, the modern European version of liberal democracy – in which taxes represent over 40 per cent of national output – may be just another staging post on the way to a new and as yet undefined order.

## Notes

(1) Colin Clark proposed in a celebrated article in *The Economic Journal* in December 1945 that, once tax exceeded 25 per cent of net national product, inflation might become an intractable problem. Lord Keynes, the editor of *The Economic Journal* at the time, was not persuaded by Clark's evidence, but said that "25 per cent taxation is about the limit of what is easily borne". A proposal to reduce government spending to a quarter of national product was given by the author in the April and May 2001 issues of this *Review.*

(2) Vito Tanzi and Ludger Schuknecht *Public Spending in the 20th Century: a Global Perspective* (Cambridge: Cambridge University Press, 2000), pp. 121 – 30 and pp. 225 – 9.

(3) Francis Fukuyama *The End of History and the Last Man* (London: Hamish Hamilton, 1992), p. 204.

(4) See Andrea Bassanini and Stefano Scarpetta 'The driving forces of economic growth: panel data evidence for the OECD countries', pp. 9 – 56, *OECD Economic Studies* (OECD: Paris, 2001), no. 33, vol 2., 2001. The key sentences are on p. 35. "Taxes and government expenditures affect growth both directly and indirectly through investment. An increase of about one percentage point in the tax pressure [i.e., the ratio of tax of GDP] – e.g. two-thirds of what was observed over the past decade in the OECD sample – could be associated with a direct reduction of about 0.3 per cent in output per capita. If the investment effect is taken into account, the overall reduction would be about 0.6 – 0.7 per cent."

(5) Tanzi and Schuknecht *Public Spending*, p. 32.

(6) Adair Turner *Just Capital: the Liberal Economy* (London: Macmillan, 2001), pp. 252 – 4.

(7) Tanzi and Schuknecht *Public Spending*, p. 103.

(8) See Tim Congdon 'Does the Eurozone face 50 years of economic stagnation?', pp. 47 – 60, *World Economics*, vol. 3, no. 2, April – June 2002. The article in *World Economics* was based on a research paper with the same title in the January 2002 issue of this *Review.*

(9) Daniel Bell *The Cultural Contradictions of Capitalism* (New York: Basic Books, 1976), pp. 237 – 8.

(10) Fukuyama *End of History*, p. 133.

(11) Fukuyama *End of History*, p. 137.