Have the Tax Cuts Saved America from Eurosclerosis?

by Ronald D. Utt, Ph.D.

As the 2004 presidential campaign gets underway, some of President George W. Bush's challengers have attempted to link his policy of aggressive tax cuts with the nation's lackluster economy since the terrorist attack on September 11, 2001. Most of the challengers have gone so far as to promise that, if elected, they will reverse some or all of the enacted and planned reductions in federal income taxes.

One candidate recently wrote in The Wall Street Journal, "As President my economic policies will be focused and clear. I will begin by repealing the 2001 and 2003 tax cuts...."[1] A few of the other challengers endorse tax hikes of the same multibillion-dollar magnitude, while those seeking to strike a more centrist pose promise to raise taxes only on the "rich" while leaving the scheduled "middle class" cuts in place.

High Taxes Hurt Europe's Economies

The implied notion that tax increases contribute to economic vitality would come as a surprise to many European governments that are now moving to adopt American-style economic policies, because these policies have yielded dramatically superior American economic performance compared to European economic performance. The most recent data indicate that America's gross domestic product (GDP) grew more than 12 times faster than the GDP of the combined European economies over the 12 months ending in June 2003.[2] (See Table 1.)

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Comparative Performance of Jobs and GDP over the Past 12 Months

Country	GDP Growth	Unemployment	
	12 months ending with the second quarter of 2003	Latest	Year Ago
Australia	2.0%	5.8%	6.2%
Austria	0.7	4.5	4.3
Belgium	0.8	13.2	12.0
Britain	2.0	5.0	5.2
Canada	1.6	8.0	7.7
Denmark	–1.0	6.1	5.1
France	–0.3	9.6	9.1
Germany	–0.2	10.5	9.8
Italy	0.3	8.7	9.0
Japan	3.0	5.1	5.5
Netherlands	–1.2	5.3	4.2
Spain	2.3	11.4	11.4
Sweden	1.1	5.4	4.1
Switzerland	–1.0	3.7	2.6
United States	2.5	6.1	5.7
Euro Area*	0.2	8.8	8.4

*Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, and Spain.

Source: Table, "Output, Demand and Jobs," published in "Economic and Financial Indicators," *The Economist*, October 18, 2003, p. 98.

As the editorial writers of The Economist observed in October 2003:

> In fact the performance of the 12 country euro area over the past five years has been a bitter disappointment. And at the heart of the poor performance lie France and Germany, which account for roughly half of euro-area GDP. Un-less France and Ger-many recover their zip, the euro area will be condemned to remain an under-achiever.[3]

Not surprisingly, both France and Germany are in the process of cutting taxes in an effort to spur growth in their economies, which have weakened considerably over the past six months--the same period during which the U.S. economy began to show signs of a much stronger recovery.

As Table 1 reveals, the widening of the gap between U.S. and European performance is partially due to the economic recessions in several European countries. Although most grew at rates slower than the U.S. economy during 2002, by early 2003 France, Germany, Switzerland, Denmark, and the Netherlands saw their economies shrink. They have also seen their unemployment rates soar, some to double-digit levels as in Belgium, Germany, and Spain. With an unemployment rate of 9.6 percent and a declining economy, France may soon join their ranks.

The Tax Cuts Worked

America's comparatively better-than-average performance over the past year (from July 2002 through June 2003) comes as no surprise to advocates of the President's tax relief initiatives. In late April 2001, The Heritage Foundation estimated that President Bush's tax cut plan would increase economic growth by an average of 0.2 percent per year and reduce the average unemployment rate over the period by 0.2 percent compared to what otherwise might have occurred in the absence of significant tax relief.[4]

Taxes were cut again in early 2003, and many economists attribute the brighter economic outlook for the next several years to the President's second round of cuts. Even The New York Times was forced to ask:

> Is it time for the skeptics to admit they were wrong about President Bush's tax cuts? To the surprise of many naysayers, economic data from the past several months suggests that the $350 billion tax-cut package may indeed have jolted the economy.[5]

Long-Term Patterns Reveal the Same Benefits

Skeptics might counter that one year's record of comparative economic performance proves little and that such differences should be analyzed over longer periods of time before inferences are drawn about how different tax policies influence relative growth patterns. The skeptics are, of course, correct in their concern about drawing confident conclusions from a one-year snapshot.

But these skeptics are likely to be disappointed by the long-term patterns, because the differences in economic performance revealed in the preceding table for early 2003 can also be found in long-term trends going back nearly three decades, as demonstrated by data compiled by the World Bank and the Organisation for Economic Co-operation and Development (OECD) since 1975.[6] With virtually no exception, the OECD data show that there is, in general, a negative correspondence between a country's economic performance and the relative growth of government spending and taxes. As the size of government increases relative to GDP, economic performance falls below trend rates of growth for those countries with more stable government shares.

Origins of Eurosclerosis

With the exception of an increase to the mid to high 30 percent range during the late 1980s, government's share of GDP in the U.S. has remained close to 32 percent since 1975, in contrast to most other industrialized countries in which the government's share has generally increased over the same period. As a consequence, per capita GDP, adjusted for purchasing power parity (PPP), has grown faster in the U.S. than it has in many of the other industrialized countries.

In 1982, for example, both France and Germany reported per capita GDPs that were about 82 percent of GDP in the U.S. But as the size of their governments has grown, their per capita GDPs have shrunk to about 74 percent in recent years. Canada, Japan, and most other European countries have followed similar trends.

Big Winners and Big Losers

Canada and Ireland offer an interesting contrast as countries that have reaped widely different economic consequences from their different tax and spending policies. From the 1970s through the late 1980s, Canada's per capita GDP averaged about 90 percent of U.S. per capita GDP.

However, beginning in the 1970s, the Canadian government's share of its economy began to expand, rising from 36 percent in 1971 (when it was just under 32 percent in the U.S.) to the 45 percent range through the mid to late 1980s and then to almost 50 percent in the early 1990s. As a consequence, economic vitality waned and Canada's per capita GDP has since hovered near 82 percent of America's.

Ireland also saw its government's share of the economy rise to more than 50 percent by the mid 1980s, but then began the process of reducing taxes and shrinking government. By 1989, the Irish government's share was under 40 percent, and it continued to fall during the 1990s until it reached about 30 percent late in the decade. As a consequence of this dramatic reversal, Ireland is now the second most prosperous country in Europe after oil-rich Norway. From a 1975 per capita GDP that was only 42 percent of America's, Ireland's economy has since experienced rapid growth, and its per capita GDP is now 94 percent of America's and 25 percent higher than that of France or Germany.

A Global Experiment

In effect, the OECD's data series since 1975 measures the results of a worldwide social science experiment in which a variety of national economic policies are "tested" and their consequences measured. Just as an earlier (and longer) experiment demonstrated the economic superiority of democratic capitalism over dictatorial socialism and thereby contributed to the demise of the Soviet Union and its empire, the more recent experiment concerning size of government and tax burden is yielding similar changes among the experiment's losers.

Finally recognizing that there is a strong connection between taxes and spending on the one hand and economic performance on the other, a number of European countries and Canada began in the early 1990s to implement policies of spending restraint to shrink that share. Canada has gone from a 50 percent share in 1992 to a 38 percent share today, while Sweden, which suffered the greatest relative decline against the U.S. economy, has gone from a staggering 68 percent government-spending share in 1993 to a 52 percent share today.

These numbers are still too high, and the governments will continue to impede their economies as they shift vast amounts of resources from the private sector to inefficient government programs. Nonetheless, progress is important, and further spending share reductions should lead to the kind of economic improvement experienced by Ireland as its once burdensome government share of the economy fell to a share slightly smaller than America's.

A World of Supply-Siders?

With spending under better control and budget deficits shrinking, many of these countries are now realizing that merely holding the line on tax increases is not enough and that tax cuts are an essential component of any policy to achieve high rates of economic growth. As a survey article in Business Week recently observed, "In what is looking increasingly like a significant break with the postwar tax-and-spend welfare state, some traditionally hesitant [European] politicians are starting to enact pro-growth policies."[7]

Over the past year, Germany, France, and Canada have initiated tax cuts in an effort to stimulate their economies and enhance their long-run growth prospects. Ignoring the European Union's mandate to keep his government's budget deficit to no more

than 3 percent of GDP (the U.S. budget deficit is now around 3.5 percent compared to 4.2 percent for France), French Prime Minister Jean-Pierre Raffarin announced plans for both personal and corporate tax cuts, while German Chancellor Gerhard Schroeder's government has moved tax cuts worth billions of euros, originally scheduled for 2005, forward to next year.

Final Thoughts

At a time when even French President Jacques Chirac is prepared to risk his political career and cultural exceptionalism by endorsing American-style, supply-side, pro-growth tax cutting policies, American presidential candidates embracing the bankrupt policies of a very Old Europe will find themselves oddly out of step and isolated from the mainstream debate about the future of the American economy. It is to be hoped that their views will mature during the coming campaign and they will acknowledge that America did not become the richest country in the world by accident.

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1. Howard Dean, "We Can Do Better," The Wall Street Journal, August 22, 2003.
2. "Economic and Financial Indicators," The Economist, October 18, 2003, p. 98.
3. "A Franco-German Beauty Contest," The Economist, October 18, 2003, p. 12.
4. D. Mark Wilson and William W. Beach, "The Economic Impact of President Bush's Tax Relief Plan," Heritage Foundation Center for Data Analysis Report No. 01-01, April 27, 2001.
5. Edmund L. Andrews, "Spotted: Evidence That the Tax Cut Worked," The New York Times, October 19, 2003.
6. World Bank, World Development Indicators 2002, Table, "GDP per Capita," at publications.worldbank.org/wdi (subscription required), and Organisation for Economic Co-operation and Development, OECD Economic Outlook No. 71, June 2002, Annex Table 26, "General Government Total Outlays."
7. John Rossant, "Is Europe Rolling?" Business Week, September 8, 2003, p. 51.