THE PATH TO SUSTAINABLE GROWTH

LESSONS FROM 20 YEARS GROWTH DIFFERENTIALS IN EUROPE

PART 3 - A CASE STUDY: IRELAND VERSUS BELGIUM

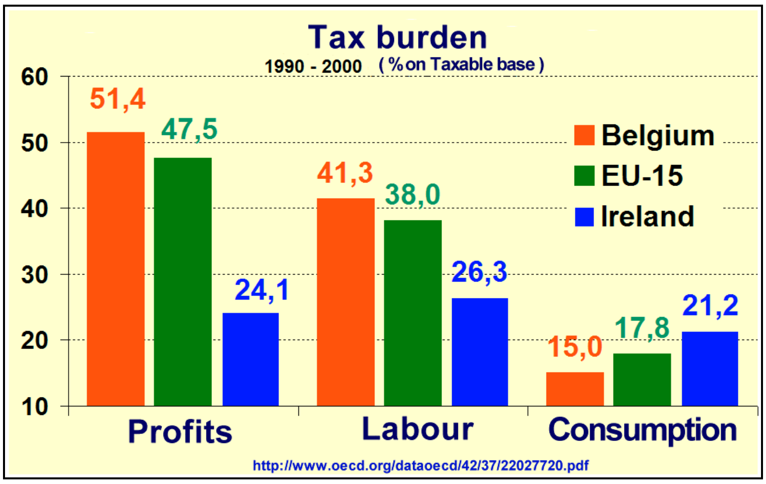
MARTIN DE VLIEGHERE AND PAUL VREYMANS

SEPT 11TH 2006 http://workforall.net

THE PATH TO SUSTAINABLE GROWTH

LESSONS FROM 20 YEARS GROWTH DIFFERENTIALS IN EUROPE

Part 3 - A Case Study: Ireland versus Belgium

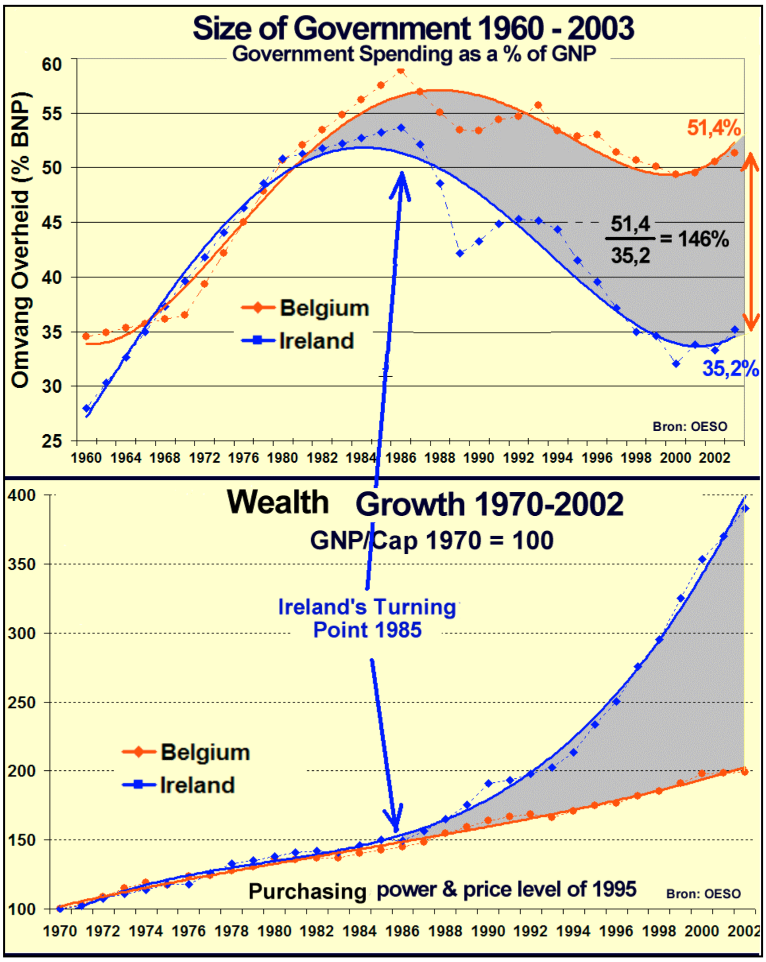


In part II we found strong evidence that the size of public spending and fiscal policy are prime factors determining growth prospects for job creation. In this chapter we analyse the effective growth and employment effects in two economically comparable countries whose tax policies are quite opposite: Ireland and Belgium.

Ireland's is characterised by relatively low public spending at 35% of GNP, whereas Belgium has high public spending at 51% of GNP (2003). Ireland's tax structure is also almost flat, whereas Belgium's tax revenues are predominantly based on direct taxes. Belgium has also low taxes on consumption.

We analyse the real effects of both taxation policies on growth, tax revenues, state budget, public debt, job creation and social expenditure.

The Effects of Tax Cuts on Growth



In 1985, Ireland's economical situation was dramatic, and even worse than Belgium's: excessive budgets deficits, weak growth performances, and a wealth that amounted to only 65% of the Belgian level. Irish unemployment reached 17 % compared with 10 % for Belgium. Until 1985 both countries followed similar Keynesian policies and government spending derailed. In 1983 Belgian public spending exceeded the psychological level of 50% of the GDP. This excessive public spending (mostly unproductive) was accompanied by a continuous increase of the tax burden and of public debt The negative spiral had begun On the graphics we can see that until 1980 Irish public spending evolved approximately in the same way as in Belgium and dismal growth performances was the fate for both countries.

Ireland's 1985 policy change.

In 1985 Ireland however changed policies dramatically. They drastically lowered the tax burden. All superfluous government spending was dropped, and in three years time public spending was reduced with no less then 20%. Ireland's economy reacted immediately with a sustained explosive wealth growth averaging 5.6% in the period 1985 until 2002. This is roughly the triple of the Belgian growth rate.

Belgium chose for a very different policy. Belgium barely lowered the tax burden at all, but tried to boost the economy with all sorts of micro-measures. Even under favourable cyclical conditions, public spending remained above the 50% GDP level. Under these policies, growth stagnated around 1,9%. In 2003 the authorities still took 51.4% of the Belgian wealth creation. In the meantime Irish Authorities had pushed back public spending to 35.2% of GDP. Today Belgian public spending is 46% larger than the Irish one, and the growth rate differential is accordingly.

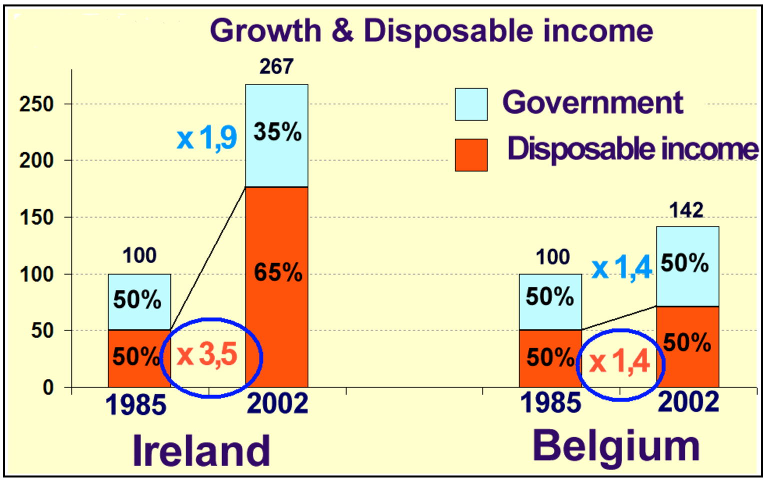
The Effects of Growth on Wealth and Policy Margin

Although the Irish prosperity in 1970 was barely half Belgium's, today it is significantly larger. As consequence of the high growth rate, Irish authorities today have large margins for all kinds of social, cultural and environmental initiatives as in absolute terms Irish government disposes of more resources than the Belgians do.

However, the Irish wealth is felt best in the purses of its citizens. The increase of the BNP/head by 167% in a 17-year period with an additional drop in the tax burden of one-third amounts to a multiplication of disposable income with no less than a factor 3.5.

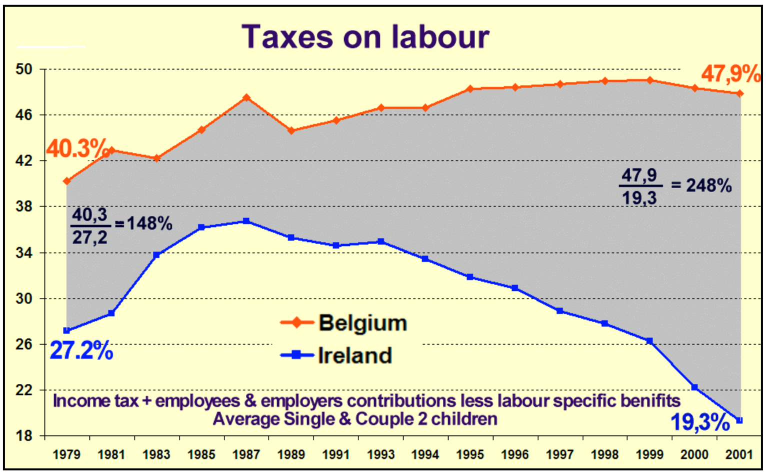
Ireland's wealth explosion is noticed in all aspects of daily life. An unequalled optimism prevails. Dublin is experiencing a construction boom and new business sprout daily. In the countryside new houses are seen everywhere, the newest car models, modern factories and offices.

The wealth is also visible in the absence of criminality, in the high birth rate and in quality of life index published by Economist magazine. Ireland is now ranked as the most pleasant country in the world to live in.



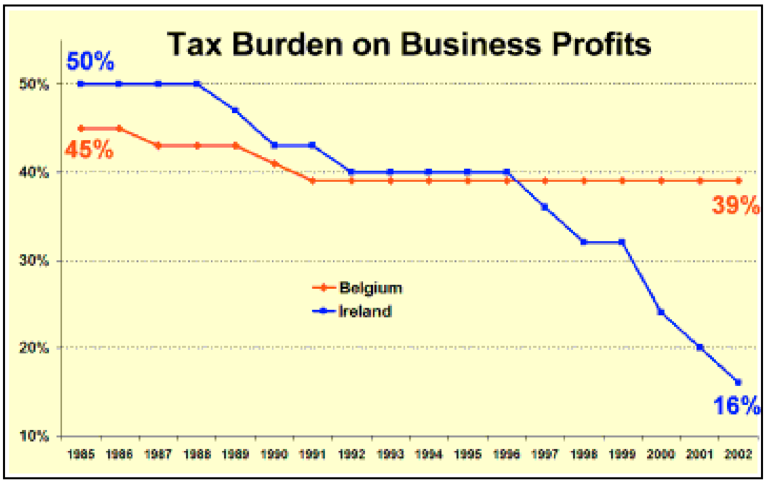
Keynesianism versus a Production-stimulating Policy

Fundamentally, a participation and production-stimulating policy consists of a substantial reduction of the total tax burden on labour and in flattening the tax structure by decreasing direct taxes. Such a tax policy motivates people back to work: it stimulates entrepreneurship, risk taking, to perform some overtime or to delay retirement. Of course, this does not work with a vague promise for a minor tax cut sometimes in the far future as is customary in many countries. Cuts must be felt immediately and they must be substantial.



Between 1985 and 2001 Ireland lowered the tax burden on wages from 37% in 1985 to 19.3% in 2001. They roughly halved the burden. In Belgium the burden on labour even slightly continued to rise from 46% in 1985 to 47.9% in 2001. Today the Belgian burden on wages is 2.5 times as high as the Irish. Not surprisingly Belgium's workers have lost their eagerness to do overtime, and businesses are exiting en masse.

However, it was the cut of corporate tax rates that brought along the greatest improvement of the entrepreneurial climate. When Ireland was at the bottom of its crisis in 1985 the corporate tax amounted to no less than 50%. In 2002, Ireland had reduced that tariff to 16%.
Belgian rate cuts on the contrary were marginal, and clearly insufficient to raise any effect at all. The recent decrease of tax rates in Belgium had to be "budgetary neutral" and was compensated by the abolishment of deductions. In fact, the cut was meant at dressing up internationally published rate tariffs, and had in fact no effect at all.



The Effects of Growth on Public Finance.

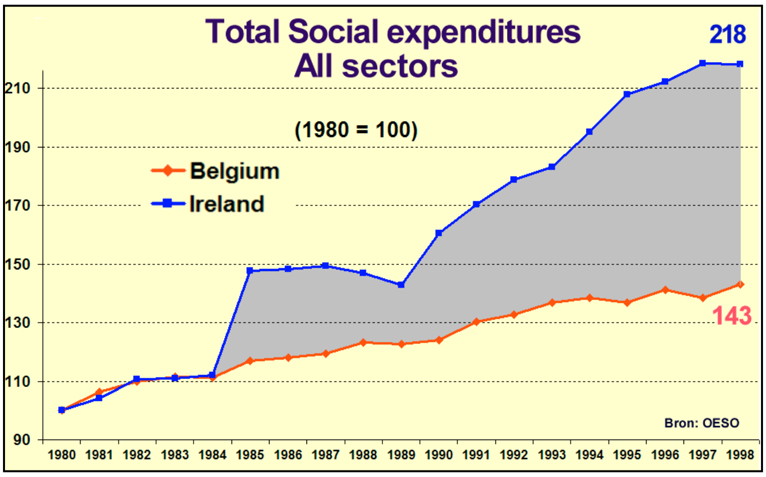
Policy maker's main fear for tax cuts result from the misunderstanding that rate cuts lead to lower tax receipts. Not so. In heavily overtaxed countries like Europe the Laffer-effects are strong. Every rate cut in fact broadens the tax base because tax evasion and fraud becomes less profitable. The Flemish government experienced a perfect example of the benefits of the Laffer-effect when they lowered estate taxes and gift taxes. Since these tax cuts the corresponding tax receipts have dramatically risen.

Moreover lowering estate taxes does not motivate to die early. If governments cut rates on incomes however, they may expect the supplementary benefits of the so-called Armey-effects. Low rates on income motivate people back to work, to perform some overtime, to start an own business, or to delay retirement. This broadens the tax base still further. Moreover, the financial resources flowing back to the private sector are invested in a more productive way than in the public sector. Ireland has demonstrated the effects of the combined Laffer-Armey effects on direct taxes all too well. Its tax receipts have continued to rise as the tax burden went down.

The Effects of Growth on Social Spending

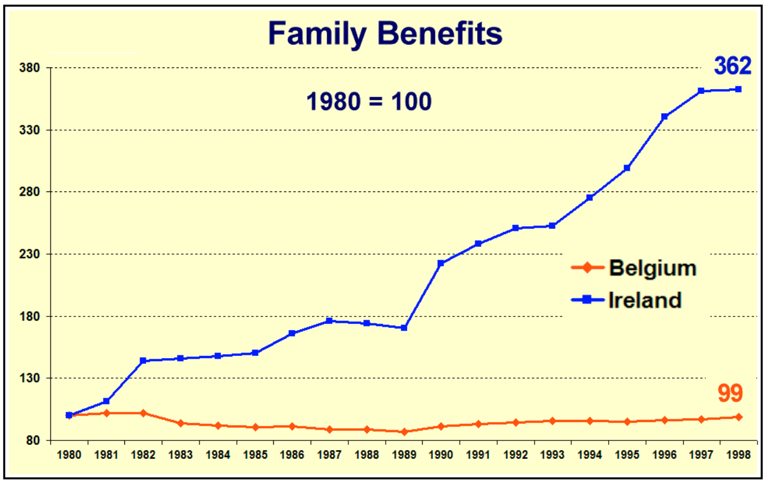
Policy makers also fear falling social spending and ultimately the destruction of the welfare state as a consequence of lowering tax rates. Ireland has again proven that the contrary happens when the tax burden is reduced.

Again this fear is based on the misunderstanding is that tax receipts fall when tax-burden falls. For direct taxes the combined Laffer and Armey effects are extremely strong, and Ireland has proven this. The tax receipts continued to rise under falling tax rates.



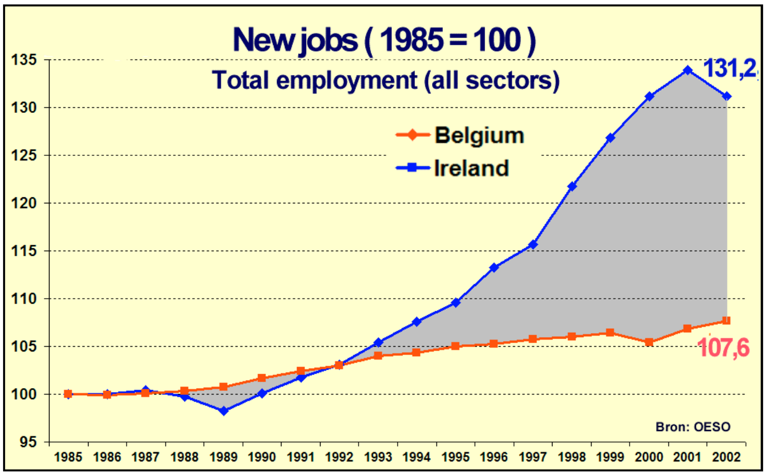
Even at constant social spending rates the dynamics of growth allow for a rise in public welfare expenditures. As a percentage of GDP, Irish social spending roughly remained constant, just as was the case in Belgium. But the stronger economic growth in Ireland has lead to an increase of social spending in real terms with 118% between 1980 and 1998. Belgian social expenditures barely grew with 43%. Ireland has demonstrated that a production-stimulating policy is in deed more social than a Keynesian demand-side policy of boosting consumption.

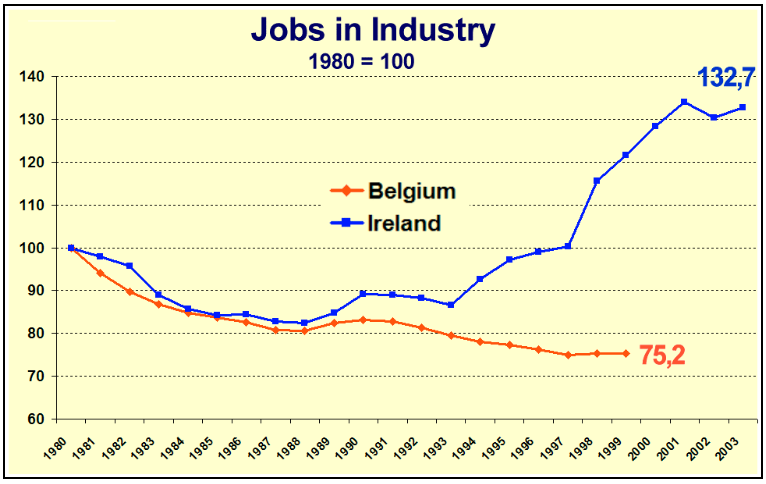
In all large sectors of social security, the real benefits have risen more in Ireland than in Belgium, except for the unemployment benefits... Of course, this is due to the drop of the Irish unemployment to one third of its 1985 level. Benefits per unemployed, are now larger in Ireland than in Belgium.



Irish are champions in family benefits, in which the child allowances are the main single item. In 18 years, the Irish family benefits rose by no less than 262%. Belgian family allowances even slightly went down. Belgians continued to focus on savings on welfare: their shrinkage scenario has opened the way to gradual destruction of their social security system.

The Effects of Growth the creation of new Jobs





All sectors combined, Ireland created 31% new jobs between 1985 and 2002. In Belgium this was barely 7,6%. The highest increase was in services: +106% compared with +15.8% in Belgium. However, most remarkably even in industry, Ireland achieved to create 32% new jobs between 1980 and 2003.

In Belgium the industrial employment in 1999 caved in to 75% of the 1980 level. Since 1999, However In agriculture the same evolution took place in both countries: a gradual decrease of the employment. However, agricultural employment today has a lower impact.

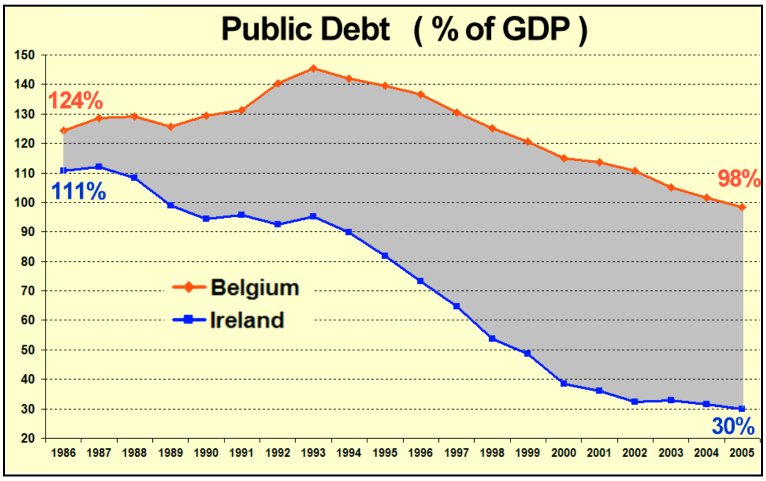
It is widely believed that European de-industrialization is an unavoidable phenomenon. Ireland has proven that it is not, and that even a European country can still increase its industrial employment

The effects of Growth on Public Debt.

Many European countries still face a gigantic state debt. This debt in many countries is the logical consequence of years of fruitless “Keynesian deficit spending”. In Belgium public debt has culminated under the disastrous administration of socialist minister of budget MATHOT, who went so far as to state publicly that deficits had come by themselves, and would go away by themselves. Of course, building up such a debt was economic insanity, and a moral injustice to the coming generations. One must get rid of these state debts. The only question is how?

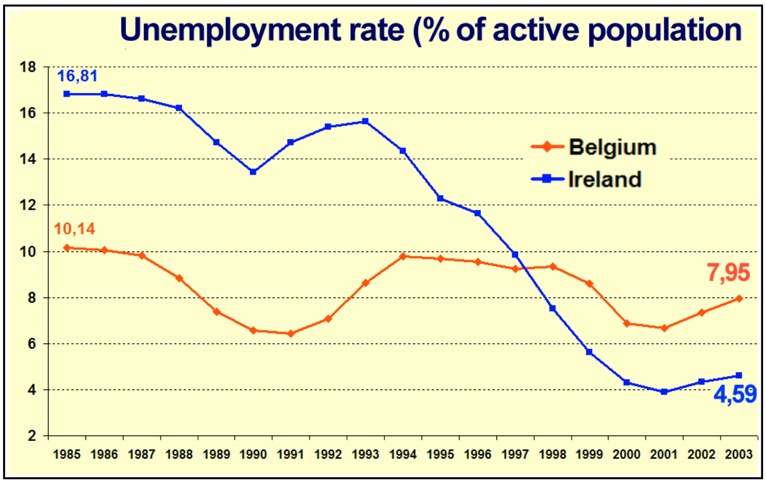
One can of course try to reimburse it as fast as possible. In Belgium, even with the huge savings rate of 14% this would take 8.85 years when they spend all savings on debt reduction. But then nothing remains to invest. Not a single machine, not a single house. They could also spread it over 17.7 years, but also then they would need to halve investments, with disastrous consequences for the competitiveness and the prosperity. Paying back public debt in this manner is much too slow, and will always be done at the expense of investment.

An alternative manner to reduce the proportion Public Debt/GDP is to focus on the denominator of this fracture, and not on the numerator. . In other words, we must focus on growth. This is exactly what the Irish have done. In 1986, Irish public debt amounted to 111% of GDP, almost just as bad as in Belgium with 124%. The Irish tax cuts however boosted growth to an average 5.6% per year, between 1985 and 2002. Belgium focused on the nominator of the fracture:. This policy had a deflationary effect and the growth stagnated at the low level of 1,9%.



After 17 year an exponential growth rate differential of over 3% works out to a gigantic difference: Ireland raised its GDP by a factor 2.67. Belgium with a factor 1.42. In other words Ireland increased the denominator of the fracture public debt / GDP with that factor 2.67, Belgium with that factor 1.42. This way Irish debt will be reduced to 30% GDP in 2005. With much effort and many new taxes, the Belgian government debt will still be at 98% of GDP

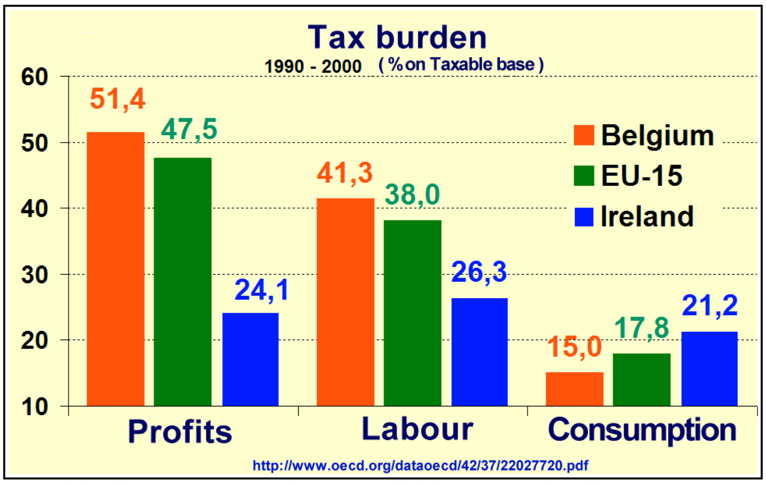
Unemployment under Supply-Side policies.



In many countries a very tough misunderstanding persists that available work is a limited static quantity that one should have to share. Nothing is less true. Tax cuts are the motor to creativity, to new initiatives and to job creation in the productive sector. This is clearly shown in the Irish unemployment statistics. In 1985, Irish unemployment was much worse than in Belgium: 17% unemployed as compared to 10%. In 2003 Ireland had reduced the figure to 4,6%. In reality, this means that Irish employers are permanently in search for workers, staff and employees, and not the other way around as is the case in Belgium.

The fear that low rates on profits and low social contributions only attract enterprises from other countries is based on the very same misunderstanding. This reasoning assumes that the number of enterprises and their size are invariable quantities that should be shared among nations. This reasoning assumes that the enthusiasm to work or start one's own business is insensitive to the tax burden. One should know better. When a larger share of the fruit of their labour is allocated to people, their readiness to productive contribution immediately increases. Low tax burden motivates to work, to perform overtime work, to take risk, to invest and to postpone retirement.

The Shift from Direct Taxes to Indirect Consumption Tax



One of the main conclusions from the regression-analysis in chapter II was that countries with higher consumption rate grow much slower than countries with a higher savings rate. Therefore a shift in taxation policy, encouraging saving could effectively spur growth.

Public spending grew explosively since the sixties. In most European countries direct taxes have taken the entire burden of this government growth. Family income taxes in Belgium doubled since 1965; taxes on consumption barely changed at all.

When the Belgian social security model was conceived, the proportion between direct and indirect tax was balanced. However, in the course of the time, the structure of tax receipts became distorted.

Economic Effects of a Tax Shifts.

- High direct taxes de-motivate productive contribution to the system

- Raising taxes on consumption allows lowering direct taxes. Lowering social contributions improve wage competitivity and stimulate growth. On individual level higher net incomes are motivating, and decrease pressures in the wage negotiations, improving competitivity further.

- A Low ratio consumption taxes/direct taxes boost consumption to the disadvantage of investment. Higher consumption taxes provide incentives to save and invest. Hereby a larger part of the (raised) private income is directed in the productive circuit. The accelerator effect of the increased income becomes a multiplicator effect through increased investments.

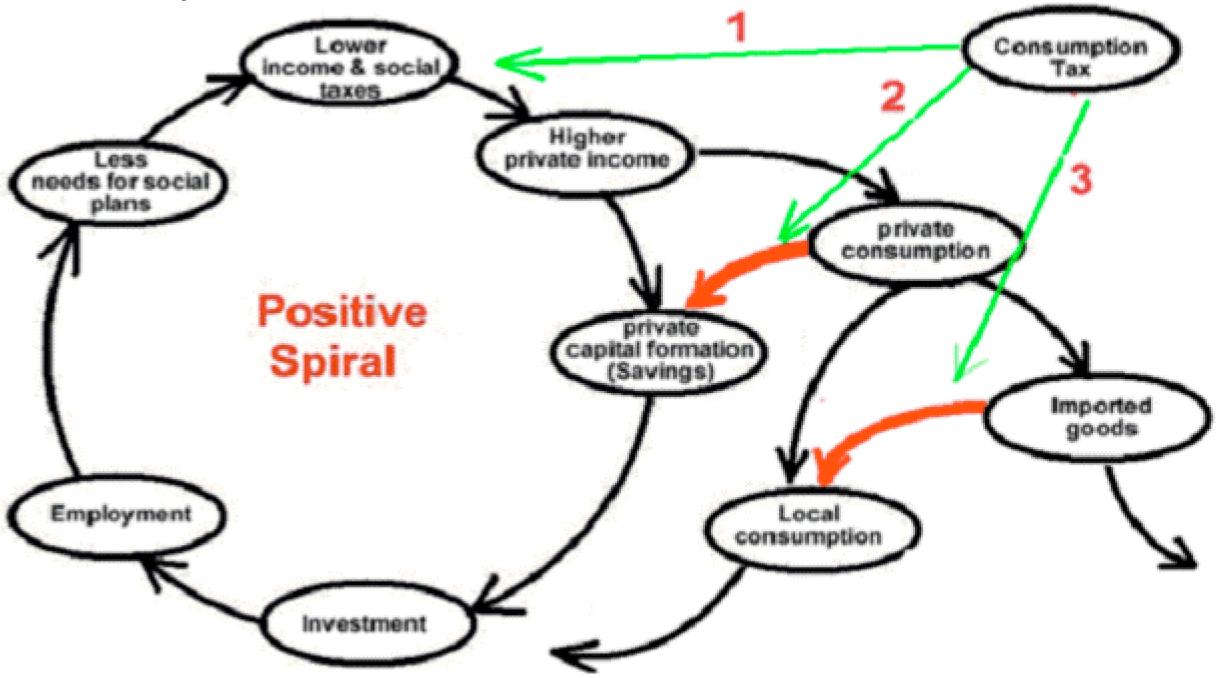
- Consumption taxes spread the burden of the social security system over foreign as well as domestic production. Products produced abroad are bearing an equal share in the burden. Under the present tax structure the tax burden of income taxes and social security contributions rests on local production only. For local producers these taxes on production are cost increasing, resulting in higher product prices. Foreign products have an unfair advantage over locally produced goods. Consumption taxes however are taxing products, regardless where a product is made. The actual competitivity advantage of foreign production can be lifted. As a consequence domestic products become competitive and can win market share, strengthening the domestic circuit, resulting in positive growth effects. These effects also concern competition within Europe.

- The present European tax structure with high tax burdens on domestic production is clearly distortionate as to comparative costs of production in different nations and therefore leads to sub-optimal worldwide division of labour and sub-optimal location of industry. Only an equal treatment of domestic and foreign production can lead to an optimal worldwide location and optimal wealth creation.

A shift of the tax burden can therefore give an additional boost to both national and worldwide growth. However the main objective must remain a substantial lowering of the total tax burden. The IMF comes to the same conclusions in their study of July 2004

Distortionate Taxes on Production cause sub-optimal Location of Industry & sub-optimal worldwide Wealth Creation

The basic idea behind globalisation is that goods should be produced in countries with the best circumstances for producing them. Countries should specialise in the production of goods and services for which they have the greatest comparative cost advantage, or in which they have the least comparative disadvantages. Such specialisation will lead to worldwide more effective production and optimal overall wealth creation profiting for all participating nations. An often heared criticism against a shift from direct taxes to consumption taxes is that raising taxes on imported goods is a form of protectionism; a trade barrier slowing down globalisation, harming the wealth effects of globalisation. This criticism makes the wrong assumption to consider domestic taxes on production a integrating part of the real comparative costs structure.



According to Ricardian theory of trade, each particular industry should be located in countries, which have the lowest comparative costs considering their state of technological development and infrastructure as well as labour costs. However taxes on production increase local costs and distort entrepreneurs' location decisions causing a sub-optimal global wealth creation. Clearly a difference shold be struck between "real" comparative advantages and fiscal comparative advantages.

The present comparative disadvantages in many sectors of European Industry do in fact not result from "real" technical causes such as faulty infrastructure, organisation, unfavourable climate, inferior technology, poor creativity or low productivity of our employees, but merely from the excessive taxation of the domestic production. In Belgium for instance wages are taxed at over 100%. These direct taxes double labour costs and cut Belgian wage productivity in half. Under these excessive production taxes even semi-labour-intensive sectors, in which Belgium -and similarly most European countries- have a technical (fiscally neutral) comparative advantage, delocalise to countries with much inferior "real" productivity.

Taxes on production have therefore the same effect as export duties: they promote imports and delocalisations and hinder exports and local investment. These "negative" import barriers distort real comparative advantages in the same manner as their "positive" counterparts do, however in the opposite direction. Direct taxes therefore prevent the optimal world-wide location of industries and optimal global international division of labour just as well as protective import duties do. Europe's heavy tax burden on production has the net effect is that Europe's exceptional productivity is sub-optimally utilised. The consequence is a sub-optimal world-wide location of industry, sub-optimal use of capital, infrastructure, resulting ultimately in world-wide wealth creation at a lower level than the actual state of technical development allows for. The negative wealth effect is particularly heavy in countries with rigid labour markets such as Belgium, where labour is difficulty transferred from delocated industries to newly developed activities.

An optimal location of industry and optimal world-wide wealth creation can only be achieved when tax systems are neutral as to their treatment of domestic and foreign production. Consumption taxes are neutral, direct taxes are not. In case direct taxes on production are replaced by consumption taxes the fiscal burden on both domestic and foreign production is equal, so that entrepreneur's location decisions are based on the real technical comparative costs only. This will finally result in goods being produced in countries where the real comparative costs are the lowest.

A shift of tax burden from direct taxes to consumption does not hinder globalisation. On the contrary: it creates the competitive conditions under which the globalised economy can reach the optimal location of industry and the optimal global wealth equilibrium.

Such a shift lifts the distortionate tax system, which provides unjust competitive advantages to nations with poorly developed social security systems. The present distortionate tax system causes permanent pressure in developed nations for gradual cuts in their social protection. Contrarily a shift from direct taxes to consumption taxes provides besides the conditions for optimal global wealth creation also the economic incentives for world-wide social development.

Social Consequences of Consumption Taxes

In the knowledge that a shift of the tax burden can bring about substantial national and global growth acceleration, the stubborn resistance of our policy makers against consumption taxes is inconceivable. Their resistance cost the world and Europe in particular wealth and jobs. Labour organisations call consumption taxes unsocial. Not so, when the alternative of job destroying direct taxes is concerned.

Big consumers pay most

The often heard criticism is that consumption taxes would be unsocial is simply not true. The big consumers simply bear the heaviest burdens. Even under flat consumption taxes, Porsche buyers pay 5 times more VAT than Fiat Panda drivers. Champagne drinkers pay 5 times more VAT than beer drinkers. Drivers in luxury limousines pay more excise duties than petrol efficient vehicles. Heavy drinkers pay more than sober citizens do. Consumption taxes are indeed social taxes by nature.

Moreover progressive rates such as usual in most countries strengthen progressivity. High rates for luxury products such as luxury cars, gadgets, cruises and luxury estates, luxury products such as caviar, lobster, for instance. Low rates for basic consumption goods such as basic food products, health service sport, medical and care for the elderly. A more social tax is scarcely conceivable, certainly in comparison with the present alternative of job destroying direct taxes. Also environment-friendly tax structure is conceivable.

Unsocial complexity of income taxes

Income taxes have now reached such a degree of complexity that normal citizens cannot longer understand all the rules and exceptions. Under such a complex system the possibilities for the rich to avoid tax (legally or otherwise) are far greater than for the poor. The opportunities to do so arise from the very complexity of the codes. So it is unsurprising to discover, as experience suggests, that the rich usually pay about as much tax under a flat-tax regime as they do under an orthodox code.

Direct taxes cause high costs of compliance, administration and enforcement

Simplicity is of course a boon in its own right. The costs merely of administering a conventionally clotted tax system are outrageous. Estimates for both the United States and Europe put the costs of compliance, administration and enforcement in the case of direct taxes at around 15% of revenue collected.

What then are the advantages of being very simple-minded when it comes to tax? Though it is impossible to be precise, that direct burden is almost certainly as nothing compared with the broader economic costs caused by the government's interfering so pervasively in the allocation of resources.

Sound Economic Policy and Politics.

Why is this not applied everywhere? For a fundamental policy change, a political majority is needed, and our politicians think short-term and often still in terms of ideology and conflict of classes. They seldom think on the common interest, and even t less on the interest of the next generation. They simply do not know the figures and are not conscious of the impact of wrong policy choices.

If Belgium had chosen in 1985 the same policies that Ireland chose; Belgians would be twice as wealthy today. The government debt would now have been reduced to 35% of the GDP, and the employers would be competing for employees. Every day delay costs us loss in employment and prosperity. To convince a political majority of such facts needs a political leader with view and especially acting power. Belgium has simply lost 20 years of progress.

The Role of the Media and Education.

The responsibility of education and of the media is overwhelming. Even today in our universities the Keynes-doctrine is still taught as a brilliant manner to boost the economy. One forgets that the theory is seventy years old, and that the ideology stems from an era of plan-economical thinking. Just as medical knowledge has evolved over the last century, economic insights have. Our doctors do no longer apply cures and equipment of the thirties.

The present generation of politicians and journalists were raised with the Keynesian doctrine, and do not realise that a new generation of economists has arisen since the thirties. In modern research the Keynes doctrine has been countered with overwhelming empirical evidence. Politicians and journalists do not realise that since they graduated the economy has come to a new understanding. Many have possibly never heard of Hayek, Laffer, Armey, Friedman or the Austrian school. It may last another generation before this becomes evident to the decision levels. Hopefully Europe won't live on an industrial graveyard under a dictatorship by then.

Abstract

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

PART 1 - *The Economics of Taxation*

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

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

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

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

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

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

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

DOWNLOAD PART 4

Loosing Overweight: A slimming Cure for fat Governments.

http://workforall.net/Slimming-Cure-for-big-Governments.pdf