The Wall Street Journal
August 2, 2005

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Even Europeans Will Respond to Incentives

By Edward C. Prescott

Medical metaphors are often used to describe an economy. We commonly hear reports of "healthy" and "strong" economies, or "sickly" and "weak" ones. In the case of Europe, with its multi-symptomatic condition, we even hear of a particular economic illness — the European Disease. This disease is marked by high tax rates, inflexible labor markets, over-regulation and resurgent protectionism, among other maladies. Prognosis? Not so good, we are told.

However, I am optimistic about Europe. Why? To paraphrase Herbert Stein's famous maxim: The current situation is unsustainable, and what is unsustainable must end. But what, exactly, is unsustainable, and why am I optimistic that Europe's current problems will give way to a new era of growth?

Let me begin to answer that question by recollecting an event that I was privileged to attend recently in Madrid. The occasion was the awarding of the prestigious Juan Llado Prize, sponsored by the Instituto de Empresa and the Jose Ortega y Gasset Foundation, given annually to work undertaken by Spanish entrepreneurs in the field of cultural patronage and research. It struck me during the course of the evening that the event — with its celebration of entrepreneurism and its recognition of a lifetime of benefits that just one successful entrepreneur could bestow on a society — was representative of what the future could hold for European countries.

The room was filled with entrepreneurs, both young and old, who were driven by ambition and persuaded by incentives to take the chances on which a vibrant economy is based. And it is more than passing coincidence that such an event would draw such a crowd in Madrid, because Spain's economy is one of the shining stars of the European Community, and its example gives hope to those countries still struggling under the yoke of misguided policies.

Spain offers a good case for European optimism. Like many of its continental neighbors, Spain was afflicted with declining labor force participation through the mid-1990s. Let's pause here to look at some facts. From 1993-96, the average hours worked (per working age person, per week) in Spain was 16.5. This compares with 17.5 hours in France and 19.3 in Germany. Clearly, Spain wasn't working.

Then, in 1998, Spain flattened its tax rate in a manner similar to the U.S. tax reforms of 1986. Coupled with labor market reforms of the previous year, Spain's labor force participation increased about 21% in the period 2000-2003, to 20 hours per week, exceeding that of Germany (18.3) and France (17.8). Correspondingly, this increase in labor participation led to increased tax revenues. (Incidentally, Spain, France and Germany all had slightly higher labor force participation rates than the United States in the early 1970s, when European tax rates were more in line with those in the United States.)

I've made this point about tax rates before on these pages but it bears repeating because it reflects a fundamental economic insight that gets to the heart of policy making: People respond to incentives. You don't make economic policy for nations, you make it for people. And it's the responses of those people, when aggregated,

that give us those data that we all love to analyze.

So, why did the European labor supply decrease by a third from the early 1970s to the mid-1990s? Because the marginal effective tax rate was increased to 60% from 40%. People chose to work less than before. Consequently, tax revenues fell. You can't raise revenues by taxing people beyond their willingness to pay. And you can't expect an economy to grow when people don't have the incentive to work, or when entrepreneurs lack the incentive to take a chance.

European countries, in other words, were approaching a point of unsustainability. Spain had reached such a point, and even though there is still progress to be made, its subsequent policy correction has worked wonders. Of course, Spain is not alone in its transformation: Britain paved the way with its earlier reforms and has since reaped the rewards from gains in labor supply, the Netherlands has also instituted important labor market reforms that have paid dividends, and some Eastern European countries are benefiting from tax reforms. It's time that the rest of Europe pay close attention to the examples of their perimeter neighbors.

Another reason for optimism is that Europe has already devised a solution to one of its thornier problems, namely, how to integrate its economies in a competitive manner that protects the property rights of other members within a country's borders. The European Union has essentially solved this problem.

With the foundation provided by its economic union, and with the examples of its newly thriving members, the groundwork is essentially laid for an economic transformation of the whole continent, including France and Germany. I am especially hopeful about Germany because, frankly, it is in worse shape and it cannot continue under the current scenario for much longer. Germany will have to act, and I expect this transformation to occur within five to 10 years. There are indications that German political leaders are moving toward more flexible labor markets; tax reform will likely follow. A shift in policy by Europe's largest economy — with its strong leadership role — will go a long way toward moving the whole EU toward an economic renewal.

Those European countries who are growing slower than they could or who are, indeed, losing ground, are reaching a breaking point. They cannot sustain their current path. They must, to return to our medical metaphor, take their medicine. For some, the remedy may not taste very good going down, but this short-run discomfort will quickly give way to the rejuvenated energy of its citizens and the long-run vigor of its economy. Europe has tried other prescriptions and those have failed; it's time to cure the European Disease by reviving the health of its people. ■

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(See related letter: *"Letters to the Editor: The Medicine Is Sound, The Diagnosis Incomplete"* — *WSJ* Aug. 4, 2005)