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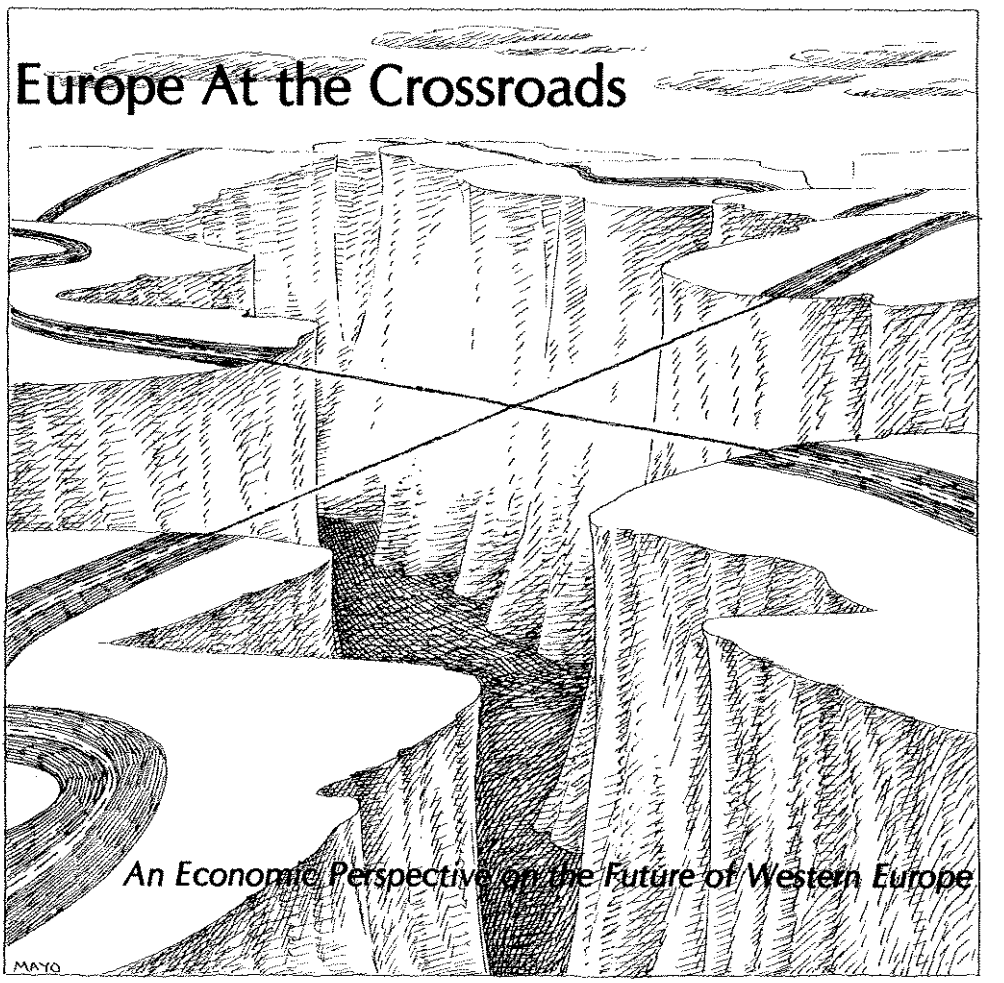

European countries were devastated by international economic shifts during the 1970s. Chief among these were the devaluation of the dollar in 1972 — after which Europe became a high-cost area of production — the oil crises, and the competitive challenge from Japan and newly-industrialized nations. Nevertheless, even in a favorable world economic climate, productivity in Western Europe would have remained at low or negative levels in the light of massive increases in public sector spending. Government expenditures in Europe — gauged as a proportion of GNP — steadily increased during the '70s and now average between 45 and 50 percent per nation. Exacerbating the instability of the private sector was the decision by many European governments to assume responsibility for employment and production in failing industries. Thus, the outright nationalization of industries now taking place in France and elsewhere in Europe is simply the last step in a process which began years ago.

To better understand the present condition of European economies, and the various directions toward which they are heading, the Manhattan Institute organized several meetings with European policy analysts this winter. The first meeting, an edited transcript of which makes up the bulk of this report, focused on policy options open to the elected leaders of Western Europe. For the second series of meetings, the Manhattan Institute invited foreign correspondents from leading European journals to discuss the economic perspective of Western European voters. Their analyses appear on pages six and seven.

William M.H. Hammett—I would like to introduce the chairman of today's session, Ted Littlejohn. He has recently retired as Vice President of Public Affairs at the Pfizer Corporation, after capably serving there many years. I've worked with him for three years now and I'm certainly going to miss him. In the spring he will be leaving for Los Angeles where he will become a visiting professor at the U.C.L.A. business school, which is their gain. Ted Littlejohn.

Edward Littlejohn—Thank you, Bill, and thank you, ladies and gentlemen. It's a pleasure to participate in this most recent of the Manhattan Policy Forums. These forums are becoming quite a tradition, and a very stimulating tradition. Fortunately, I have the easiest task here today, which is simply to introduce the speakers and then to fade into the background.

The first speaker today is Tom Bethell, who will talk about the economic situation in Britain. Tom was born and educated in England and has just come back from his latest tour there. He has a regular column in the *Spectator* of London and is a contributing editor to *Harper's* and *The American Spectator*, and he currently holds the DeWitt Wallace chair in communications at the American Enterprise Institute. Tom Bethell.

Tom Bethell—Thank you very much. I'd like to address the subject of the British economy, first of all, by considering a syllogism we are frequently hearing today in the United States. The syllogism goes roughly as follows. First premise: President Reagan has implemented the Thatcher program. The second premise: the Thatcher program consists of spending cuts, tax cuts, and tight money. Third premise: the Thatcher program has failed. Conclusion: therefore, the Reagan program will fail. This argument has been perhaps best expressed by Felix Rohatyn of the Municipal Assistance Corporation. At some point in his interminable series of articles in the *New York Review of Books*, Rohatyn commented: "In Margaret Thatcher's England, the Anglican Church seems to have been replaced by the sayings of Milton Friedman. Income tax cuts coupled with sales tax increases, government spending cuts together with tight money, have after a year and a half resulted in a 20 percent rate of inflation, an 8 percent of manufacturing output, and the highest level of unemployment since the depression."

Well, let's look at some of these figures in a little bit more detail to see whether the syllogism that I had earlier mentioned holds true. First of all, the Thatcher program allegedly brought in spending cuts. In the last full year of the Labor government, fiscal year 1978 to 1979, government spending accounted for 41.5 percent of the GNP, or GDP as they say in England. In the first full year of the Conservative government, this percentage has risen to 44.5 percent of the GNP. In the next full year it is likely to remain at approximately the same level.

Margaret Thatcher has not reduced government spending. She has increased it. One of the main problems was that she felt bound by the decisions of her predecessors and felt that she had to uphold the findings of the Clegg Pay Commission. Said commission recommended a 25 percent increase in pay for civil servants, and increases in other areas of government spending. In short, Mrs. Thatcher has found it impossible to cut spending.

Secondly, with regard to taxes, taxes accounted for 34 percent of GNP in the last full year of the Labor government. By 1980 taxes had increased to 36 percent of the GNP. This is an interesting case because part of the reason for the increase in taxes in England after the Conservative government came into power was the result of what you might call the natural curve effect. The top tax rate on income in England was reduced from 83 percent to 60 percent and this resulted in an increase in revenue from that

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"I don't think Milton Friedman would regard England's 19.7 percent increase in M-3 as a tight money policy."—Tom Bethell

bracket. Similarly, of course, there was a huge increase in VAT (Value Added Tax), national sales tax, which brought in additional revenue but, significantly, did not bring in as much revenue as was projected.

Thirdly, as a part of the Thatcher program, the budget deficit or public spending borrowing requirements as they are called, in the first year of the Thatcher government was supposed to be 3.5 percent of GNP, but in fact, the deficit rose to 6 percent of GNP. This compares to what we have in the United States today, a figure of between 2 and 3 percent. So, the deficit has also gone up.

As for tight money and Milton Friedman supposedly replacing the Anglican Church, although the monetary M-3 target for the first full year was supposed to be in the range of 7 to 11 percent, in actual fact the monetary growth was 19.7 percent. I don't think that Milton Friedman would regard that as particularly tight money.

In my opinion, the Thatcher program as it is now operating will not succeed because of several basic structural problems which are not being addressed. In the first place, income tax rates in England are far too high. You encounter the 40 percent marginal tax bracket at the equivalent of $20,250. You encounter the 50 percent bracket at approximately $30,000, and you encounter the 60 percent bracket at $50,000. Similarly, for unearned or investment income, you encounter a 75 percent tax bracket also at approximately $50,000.

Another basic problem with the English economy at the moment is the harmful structure of low corporate income taxes and high personal income taxes. If you have low corporate taxes, this has the effect of turning corporations into instruments of disguised consumption. You can keep the money away from the government if you spend it in the form of perks and so on. The high personal income taxes means that it is very difficult to save money, and therefore it is difficult for the true dynamism of the competitive economy to show up in the form of new companies that compete with existing companies. This competition, this tension between the future and the present, which is what really makes capitalism work, cannot work if you have low taxes on corporations and high taxes on individuals. It should be the other way around, or the tendency should be in the opposite direction.

A third problem with the British economy right now is the serious poverty trap created by the welfare state at low income levels. Welfare benefits are so generous that there is a strong disincentive to work, or if you are working, to earn more money. Someone in England with gross weekly earnings of £45 a week—and the average wage in England at the moment is about £120 a week—will take home £64 a week. However, if his wage goes up to £75 a week, his take-home pay goes down to £60 a week because he then loses eligibility for various welfare benefits and his tax rate increases at that higher income level. Comparing the gain in employment, a married man with two children earning £95 a week in November of 1980 would take home £67. But if that person was unem-

Photo by Craig Terry

"Europe At the Crossroads" panelists (from left to right): **Tom Bethell,** *Harper's;* **Yves Guihannec,** *Le Figaro;* **Roland Vaubel,** *Institute of World Economics* in Kiel; **Melvyn Krauss,** *Hoover Institution;* **Pentti Kouri,** *New York University;* **Ted Littlejohn,** *U.C.L.A.*

"The road to serfdom is not a short road; it is the evolution of free-market economies into socialistic states."—Melvyn Krauss

ployed, he would be eligible for £70 a week.

So, there is no discussion in the British press at the moment of these problems that I have raised. Despite all of the discussion about monetarism and about trying to get the money supply under control, there is no discussion of trying to lower these tax rates, which are prohibitively high. My conclusion is that if Reagan does, in fact, enact the Thatcher program, then Reaganomics will fail.

E. Littlejohn— Thank you, Mr. Bethell. I am going to call on Mr. Krauss next to talk about another welfare state, Sweden. Mr. Krauss is a Senior Fellow at the Hoover Institution and author of *The New Protectionism*, published by New York University Press. He has recently finished a book entitled *Development Without Aid*, which will be published by McGraw-Hill this fall. He has done a great deal of research on the Swedish welfare state, some of which has been published in the *Wall Street Journal*. Mr. Krauss.

Melvyn B. Krauss—Thank you very much. Today, as most of us know, originally we were supposed to have Professor Hayek here, and Professor Hayek came to the public eye with his great book, *The Road to Serfdom*. I'd like to frame my comments in line with the insights that Professor Hayek gave us about the road to serfdom.

The first thing to be mentioned is that Professor Hayek was not interested in revolution; he was more interested in evolution. The road to serfdom is not a short road that was traveled by revolution. Rather, it is the evolution of free-market capitalistic economies into socialistic states.

Now, on the road to serfdom I can see four stops. The first stop from free-market capitalism is the "safety net." The safety net is established to help people who, for some reason, whether it's their own fault or not, have fallen and can't make their way in the world.

The second stop on the road to serfdom is the conservative welfare state, which is a term that Irving Kristol has made famous. The conservative welfare state is more than the safety net. It is an elaborate system of social programs, income redistribution, public goods programs, public health, and public education. The thing that makes such a state conservative—which is an ironic title for many of us—is that the leaders of the conservative welfare state are very much aware that a healthy economy is important for the survival of the social programs. I would say Sweden was in the stage of the conservative welfare state in the early 60s and late 50s. The gurus and the leaders of that society were very much in favor of labor mobility, that workers should be moved or move from low productivity areas to high productivity areas. This was not for social reasons, but was for reasons of the economy. It was feared that the economic base of the community would suffer if resources were left in low productivity uses. That is strikingly different from the next stop in this journey, which is the egalitarian welfare state.

The egalitarian welfare state is much more than just social programs. It's the difference between, say, free medical care for the poor and free medical care for everybody. In the egalitarian welfare state, there is a cavalier attitude toward the economy. For example, take labor mobility. Labor mobility now is something that is frowned upon in Sweden. The official line is that labor mobility is no good. Workers shouldn't move because workers have a right to a job in a profession of their choice in a geographic location of their choice. Just as you have the right of free speech, and freedom of religion, you have a right to a job of your choice in your local area. If you happen to be in a job which produces things no one wants, well then, the government's obligation is to guarantee your right by subsidizing that particular job. Now, at first the subsidies are in the form of transfer payments from the government to the firm, but sometimes that kind of subsidization is not sufficient, and the government feels that it must move in and take the industry over altogether. And so, in the last four or five years of so-called conservative government in Sweden, the number of nationalizations of private enterprise has been greater than in forty years under the Social Democrats. Why? Because they are ideological socialists in disguise, so to speak? No. It's because they don't want to rock the boat. They don't want to rock the egalitarian welfare state boat, they don't want to deprive poor people of their economic rights.

It is interesting how this egalitarian welfare state leads to the next step in the journey, which is full-blown socialism. Because, as you have seen by this little example of guaranteeing economic rights, the egalitarian welfare state leads to nationalization. Before you know it, nationalization means public ownership of the means of production and that is, of course, the essence — one aspect of the essence — of full-blown socialism.

Now, as to some of the characteristics of the egalitarian welfare state — which I think is the stage that Sweden is deeply in, and heading towards full-blown socialism. The Scandinavians have made democracy their god and I feel that they are being destroyed by that god. For the question is, does traveling along the road to serfdom make serfs out of those who take that road?

"There is something specific about the road taken by the French—the will to nationalize prosperous industries to change the structure of power in the country."
—Yves Guihannec

Now, how is democracy destroying the people of Northern Europe, and how is democracy making serfs of these people? Well, the first thing to note is that democracy is a way of making decisions by groups as opposed to individuals. This is important because in the egalitarian welfare state, the group is the central economic actor as opposed to the individual who would be the central economic actor in free-market capitalism. So it is the groups that are making the decisions.

A lot of individuals who work for trade unions are having the fundamental economic decisions — how much should I work for, how many hours should I work, should I get paid for overtime, how much overtime — resolved for them by the trade union leaders. In other words, by the leaders of groups. The same thing holds for business firms who are represented in these national collective bargaining sessions by employer organizations. And, of course, the people who work for the government are represented by the trade unions in the public sector. So you have in Sweden, and I think throughout Northern Europe, a corporate state type of apparatus; what Mussolini had in mind for Italy. Whenever you hear that it is very easy to solve the economy's problems by getting big labor, government and big business to sit down at the table and work things out—á la Felix Rohatyn—that is the corporate-state approach. That is the dominant approach in Sweden and Northern Europe. Bear in mind, once again, that it is the groups and the leaders of the groups that are making the decisions; the individuals have to adjust their behavior to those decisions made by their leaders.

I'd like to somehow apply that thought to some of the phenomena that are happening in Northern Europe today. Not only have individuals lost control of their fate because their leaders are making the decisions for them, which would be demoralizing for obvious reasons, but because of the growth of the government, high taxes and the underground economy phenomena.

This can't help but be demoralizing. Not only to the people who are cheating but also to the young people. Young people see their parents and everyone they know with some kind of tax dodge. This analysis is, of course, superficial — it hits on only one particular aspect — but I think that the message holds nonetheless. The European peoples are demoralized. The growth of big government and high taxes is leading them to behave in ways they themselves feel are wrong. In other words, private moral values are conflicting with social moral values. Europe has lost a good deal of control over its destiny because democracy has been extended past its legitimate boundaries.

Photo by Craig Terry
Yves Guihannec, *Le Figaro*

E. Littlejohn— Thank you, Mr. Krauss. Our next contributor is Yves Guihannec, economics editor of *Le Figaro.* He studied economics at Oxford and worked as an English merchant banker before becoming a journalist. Manhattan Institute had the good sense to bring him to the United States to write a book on the French economy. But I hope today he will tell us where France stands on the continuum to which Mr. Krauss has referred.

Yves Guihannec—I was listening to Mr. Krauss and I was wondering whether there is a similarity between what's going on in France and what's going on in Britain or Sweden. And the more I was listening, the more I thought perhaps, in fact, it was far less than I thought before I came here. I'd like to start with that point. I would like to question whether what's happening in France is typically French or whether it's just another form of socialism, of which there are other forms in Sweden or Britain.

I just would like to bring out the very different features of the French Socialist experiment compared to, say, Sweden. French socialists would regard Sweden as an example of what should never be done. This is what they call social democracy. French socialists are great admirers of Marxist theories. To them Sweden is not at all a road to socialism; it is a road to failure. French socialists see Sweden as a social democracy in which the production is still totally capitalist; you have a capitalist organization of production and a socialist redistribution of income. And this, they say, is social democracy, and this can never work. They maintain that the structure of power in the country must be radically changed by a reorganization of production itself, which is the old socialist tenet.

(Continued on page 8)

From the Voters' Perspective

Americans have always had a difficult time properly gauging the attitudes of Europeans. European journalists have a far better perspective on the attitudes of their countrymen than the American press corps. Because of this, we asked some of the highest-ranking foreign correspondents in New York to assess the reaction of European voters to the varying forms of economic policy now being tested throughout the free world.

Participants:

Nicole Bernheim, *Le Monde*
Hans Jurgensen, *Frankfurter Allgemeine Zeitung*
Mauro Calamandrei, *L'Espresso*
Jes Rau, *Die Zeit*
Michael Hamlyn, *The London Times*
Jan Magnus Fahlstrom, *Dagens Nyeter*
Alfred Von Krusenstiern, *Springer News Service*

MR—How does the French business community view Reagan's supply-side policy?

Nicole Bernheim—At the beginning the French were overjoyed by Reagan. We hadn't seen that type of economic policy for a long time. Also, the French business community was so shaken by the election of Mitterrand that Reagan became their only savior—other than Thatcher—in the Western world. But now they view his policies as a failure.

MR—What about in Germany?

Hans Jurgensen—My feeling is that Germans haven't given up on Reagan yet. I think the general feeling in Germany is that Reagan is somebody who is really trying something different based on fairly reasonable and healthy principles. I think he also came along at a time when we in Germany, and other European countries, had reached the point where the policies of the welfare state could no longer continue if we were not to fall into economic disrepair.

Mauro Calamandrei—As far as Italy is concerned, the Reagan revolution has had an enormous impact. In private conversations, both politicians and the people who actually run the government are very grateful that this country has changed course in a radical way. The key problem for the Italian politician for several years now has been "How do we control the budget?" And each year the problem gets worse because of all the organized special interest groups, each with their own demands for government protection. The change in the American approach has made it possible for the Italian government to be more venturous in containing expenses. Despite all of Reagan's problems with Congress in getting what he wants, the signal from the United States has been quite clear and has had a great impact in Italy. We are now really in a different age.

Bernheim—But if he fails?

Jurgensen—If he fails there will be no turning back to the normal conditions of a free market.

Calamandrei—There is another group in Italy which has a great admiration for Reagan and is very interested in what is happening here. These are all the small enterprises. The Italian economy is really divided into two parts. There are the big industries—mostly government owned—who have, since the '60s, been losing millions

"Italian entrepreneurs have great sympathy and admiration for Reagan because of his glorification of entrepreneurship."
—Mauro Calamandrei

of dollars every year. And then there is this other area of the economy which increases each year. They are the hundreds and hundreds of small enterprises, which really are the backbone of the economy. These enterprises, unlike the government controlled corporations, take the entrepreneurial risks which lead to the innovative changes necessary for productive change. They also have the advantage of being able to hide much of their income from the government, so they don't pay the confiscatory taxes which so cripple other industries. (This underground economy may amount to as much as 35 percent of the G.N.P.) So these Italian entrepreneurs have a great sympathy and admiration for Reagan because of his promotion and glorification of free enterprise in the spirit embodied by the new Italian entrepreneurs. They also support his economic policies which lower taxes and regulations for small businesses for the same reason.

MR—I would like to get your impressions of the American business community — how it differs from the European market and how you think it will fare under Reagan's economic policy measures.

Alfred Von Krusenstiern—To me, the whole approach to any economic enterprise is different in this country. Americans even have a different approach to money here. Money isn't taken all that seriously here, when compared to Germany. One almost gets an impression that from the time Germans are old enough to talk, one of the first things they ask about is their pension. If some young man or woman applies for a job right out of college here, I've never heard of his bringing up the subject of his pension. However, in Germany, if a high school graduate applies for the job of messenger, his first question is "What is my pension plan?"

One thing that shocked me when I first came to the United States was that this was, at that time, the only industrial nation in the world which punished savers. And I am still appalled by that fact. Just before I left Germany, the government gave me a 25 percent bonus on the interest my savings account was earning. And here I have to pay a penalty for saving. It's preposterous.

MR—That's the legacy of Keynes. Keynes saw savings as leakage from the system and recommended issuing penalties for saving income. Savers suffer today from those same Keynesian policy measures instituted half a century ago. That's one of the things that the new supply-side approach to economic policy is trying to turn around.

What do the Swedes think of the "Reagan Revolution"?

Jan Magnus Fahlstrom—Of course, after Olof Palme, we had exactly the same arguments put forth as the Reagan people put forth — less government, lower taxes, etc. But nothing much came of it, even after a more conservative party was voted into office. So now we still have high inflation, high taxes, low productivity, and all the accompanying problems, like a very low savings rate.

Hamlyn—England has an interesting perspective on Reagan's economic policies in that we regard ourselves as being on the cutting edge of this experiment. The Thatcher government has tried to roll back the liberal policies of the past,

(Continued on back cover)

The Vital Statistics

	Maximum Marginal Tax Rates on Personal Income	Government Portion of GNP	Annual Monetary Growth (M-1, 1970-80 Avg.)
France:	60% (1979)	46.3% (1980) 35.7% (1961)	11.2%
West Germany:	56% (1979)	46.1% (1980) 33.4% (1961)	9.9%
United Kingdom:	83% (1979)	44.3% (1980) 33.3% (1961)	13.1%
Sweden:	86% (1979)	63.2% (1980) 31.1% (1961)	13.5%
	(Source: *Institute of World Economics*, Kiel, West Germany)		(Source: *Federal Reserve Bank* of St. Louis)

(Continued from page 5)
They would argue that this is not happening and cannot happen in a social democracy. There has to be what they call now the "break from capitalism," to avoid the word "revolution." There has to be, in the French socialist view, a change in the structure of power. The people who produce must be new people. This is the idea of the nationalization bill.

Although there may be some rapid nationalizations in Sweden, the credit system is not nationalized in Sweden and only industries that were in great difficulties were nationalized. There is something specific about the French road which is the will to nationalize prosperous industries to change the structure of power in the country. This is a revolutionary idea. Mitterrand will explicitly refer to experiments like that of Chile under Salvador Allende, for example. As you know, when he was inaugurated he had a great do at the presidential palace and on his right, and then at the state dinner, was Mrs. Allende. Now, he is not saying that he is a Marxist in the true revolutionary — again, the censored word — sense of the word. But he was trying to emphasize in that way that really what has been done in France is a clear break from northern social democracies.

So the question really is: Does the French experiment take its roots in socialist theory, or does it take its roots in French history? Mitterrand is playing on the two affiliations all the time. To his left, when he wants to sound like a real revolutionary, he goes back to the sacred text of socialism. When he is speaking to the French people at large, he tends to take a more traditional view. In this traditional view, of course, nationalization takes on a different meaning. And I think that people abroad — and perhaps even in France — don't realize how much we already have gone *that* way — towards more and more state control. I'm not talking about the redistribution system. I'm talking about the structural power in France.

One must know that all the private banks that are not being nationalized are already, in France, run by former civil servants. One can't name one head of any big French private bank who is not a former civil servant. And you'll find the same even if you look at industrial corporations. And this was the case under Giscard, as well. And this has been increasing throughout the twentieth century. If you look at any *Who's Who* in France, you'll find that you really do have a state system. So I think, in a way, it's true that Mitterrand's election is a break. It probably is more a break in rhetoric than it is in real life, however. Because the structure was there already. And this leads me to my last question.

Is this reversible or not? Will certain classes like, say, the small businessmen or some parts of the middle classes, have enough power to reverse this trend? I'm sad to say, I don't believe so. If the Right comes back to power one day we may see some denationalization. But I can't see how we'll move away from state control, although I am going to write and act as if I believed this was the case. Because one has to believe in these things, otherwise it's going to get worse and worse.

I'm sort of like Hayek or Schumpeter on this question: Act as if you thought it was avoidable. But it probably isn't avoidable and we're probably going to see more and more state power in France, and that's it.

E. Littlejohn— Before we come again to the northern part of Europe I think we'll go to Germany and later come back to Finland and Scandinavia, in general.

Roland Vaubel has been a visiting professor at the University of Chicago. His home base is the prestigious Instititue of World Economics in Kiel and he will shed some light on West German economic affairs. Dr. Vaubel.

Roland Vaubel—Thank you. I shall start with a few figures which I think will highlight — shed some light on — the present economic situation in Germany. I shall then focus on the growth of the German welfare state and especially on what's being done about it, or rather, what's *not* being done about it.

Real GNP growth in Germany, in '81, is negative, minus .5 to 1 percent. The forecasts are that in '82 it will be negative again or possibly positive up to 1 percent. This comes after an annual average growth rate of about 3.5 percent for the last five years.

Unemployment is now, in November, at 6.4 percent. The average for '81 will be 5.5 percent.

Photo by Craig Terry

Participants **William Hammett,** *Manhattan Institute* (l) and **Edwin Newman,** *NBC News*

"The Social Democrats in West Germany are not willing to accept a fundamental dismantling of the welfare state."—Roland Vaubel

The forecast for '82 is about 7 percent. This comes after an average of 4.3 percent in the last five years and an average of 1 percent in the '60s. What these two statistics show is that Germany is in a very severe recession. The question is: what are the reasons for this recession?

I see four major reasons: First, a drastic and sustained monetary deceleration. Second, deteriorating terms of trade due to all price increases and the dollar appreciation. Third, increasing real unit labor costs. Fourth, the extensive welfare state which we have in Germany now, which absorbs a larger and larger part of production in the low productivity sector, which reduces work incentive and, most of all, which reduces the willingness to adapt to structural change.

The share of total government expenditure in GNP in the first half of '81 was 49 percent. This compares with 38 percent in '69, the last year in which the Christian Democrats were in power, and with 32.5 percent in 1960. So you see, there has been a drastic increase.

Apart from Social Security, you have the surprising fact that the share of federal government expenditure has fallen over the last twelve years. It was 65.5 percent of total public spending in '69. It's now 63.5 percent. So, most of the government growth has taken place at the lower level government. But that doesn't mean that the federal government is not the cause of this government expenditure growth. Because what has happened is that the federal government has redistributed tax revenue on a large scale towards the lower level government. Moreover it has introduced matching grants on a large scale which induced the lower level governments to increase expenditure.

Now, what the government did was after redistributing tax revenue to the lower level government, it made up for the loss of tax revenue through borrowing. This was a very tricky move. It was a way of keeping the effect of government growth invisible as far as the federal government was concerned, although the federal government was the driving force. It was very tricky because in '69 when the Social Democratic government came to power, the lower level governments were heavily indebted, whereas the federal government was not, owing to twenty years of Christian Democratic rule.

Obviously, this increase in government borrowing led to a ballooning budget deficit. In the first half of '81 the total government budget deficit amounted to 4.1 percent of GNP—the largest ever—and if you adjusted what were the effects of the recession, you still have 3.7 percent, again the largest ever. In 1980, the deficit was still 3.4 percent. In the '60s, the average was a sizeable surplus.

You may have read in newspapers about efforts to reduce the deficit and to curb the increase in government spending. The federal government is trying to reduce its deficits by one-third in '82 by raising excise taxes on alcohol and tobacco; reducing subsidies for agriculture, child care, low income housing and research and development, and cutting some expenditures on which I shall have more to say in a minute.

Nevertheless, the recession-adjusted deficit for the total government sector will not decrease in '82 as a result.

What sort of government expenditures have been cut? First, there's a cut—or there's supposed to be—in government personnel of 1 percent. Secondly, there's supposed to be a cut in the public sector base wage, of 1 percent. The next wage increase in the public sector is to be postponed if the unions agree. There are very severe cuts with respect to labor market policies, especially retraining. There are stricter eligibility requirements for unemployment benefits. There are reduced reimbursements from the state health insurance.

The Second Chamber of Parliament, which is dominated by the Christian Democrats, wants further cuts. They want conversion of all student grants into loans. They feel welfare payments should be cut or be converted to loans. They want a cut in the replacement rate of unemployment insurance from 68 to 62 percent. The Christian Democrats object to the planned increase in the contributions to the unemployment insurance from 3 to 4 percent. The Christian Democrats want to cut the entrance salary of civil servants by 10 percent. And the Christian Democrats object to the planned abolition of the child care allowances in income taxation.

Apart from these disagreements between the government and the opposition, there are also very striking disagreements within the government, between the Social Democrats and the Free Democrats. The Social Democrats want—and always wanted—a large expenditure program to stimulate the economy. They are in favor of old-fashioned Keynesian demand-management. The Free Democrats have vetoed this plan. The Free Democrats want a larger increase in depreciation allowances and they want there to be no immediate continuation of wage payments in the case of sickness, which under the present law employers are required to guarantee. In other words, they want a waiting period. This has been vetoed by the Social Democrats. To summarize, the Social Democrats are quite willing to correct what they call "minor abuses" of the welfare system. They are not willing to accept what the Free Democrats

"In the egalitarian welfare state, the group is the central actor, as opposed to the individual who would be the central actor in free-market capitalism."
—Melvyn Krauss

and the Christian Democrats want, namely, a fundamental change, a fundamental dismantling of the welfare state.

E. Littlejohn—Thank you, Dr. Vaubel. And now to Finland. Our next speaker is Pentti Kouri, Professor of Economics at New York University. Finland is his native country and where he spends considerable time. I will now ask him to round out the panel by speaking on the subject of Finland.

Pentti Kouri—Thank you, Mr. Chairman. I thought I would start with some remarks on the overall situation in the European economies and conclude with some observations on Finland and Sweden.

What were the reasons for the spectacular performance of the European economies during the quarter of a century after World War II? In economic relationships between countries, if there are no impediments to trade, the income level in the country that starts at the lower level will rise through capital accumulation. And this is exactly what happened in Europe after World War II. Europe was catching up with the United States. And the United States provided Europe with advanced technology — with Marshall aid in the first place — and then extensive investments by American corporations in Europe in the 1960s. And the United States also provided Europe with monetary stability in the framework of the Bretton Woods system.

(It's interesting to observe — as much as we talk about inflation today and the deep-rooted causes of inflation — that from 1951 to 1970 the prices of international trade in U.S. dollars did not change at all. The price level in 1970 was virtually the same as it was in 1951.)

What explains the end of growth in Europe and the problems that we are currently witnessing? Now, even in the best of circumstances, if no external circumstances in the world economy had upset Europe — if OPEC had never increased the price of oil or if Japan had never entered the picture — I think it was inevitable for the rate of growth in Europe to slow down as the technology gap was closed. In the simplified paradigm that I mentioned, growth comes to an end when Europe reaches the United States in terms of its capital intensity and in terms of its technological sophistication.

Of course, the primary factor which exacerbated this decline in European countries was the growth of the social welfare state. In all European countries the welfare state was built and conceived in the years of rapid economic growth in the 1960s. But these programs were carried out in the conditions of slow growth in the 1970s.

So, all of these factors together meant that this gap, which previously worked in Europe's favor in the years prior to 1970, now worked against Europe. It reduced profitability to accumulate capital and reduced the profitability of employing labor in all the European countries.

Now, in that situation, there are two options. One alternative is to lower wage costs in such a way as to make it profitable for firms to employ these workers in the private sector, and also to make it profitable for firms to create additional jobs to employ additional workers.

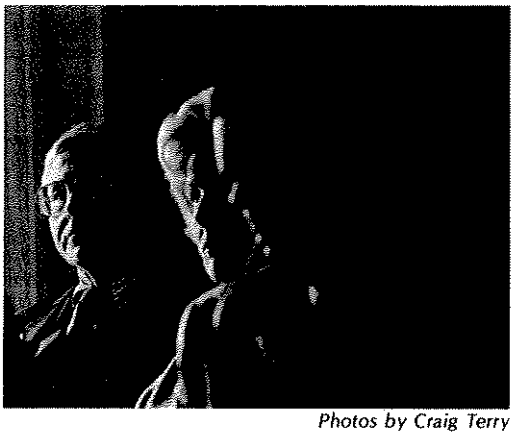
"If you look at the structure of employment in Sweden, you must draw two schedules: employment in the public sector, and employment in the private sector."—Pentti Kouri

The other alternative is to interpret the unemployment problem, and the problem of stagnation, as a cyclical problem and to say that in this situation it is the role of the government to stabilize the economy and to employ these workers directly in the government sector, or to subsidize employment because the problem is viewed as a transitory problem in nature. And that is, basically, the policy choice which was made in the European countries. And the result is that after 1973, the private sector in Europe has stagnated.

Let me conclude by making some observations on Finland and Sweden. Now both of these countries were basically in the same situation in the early 1970s. Somewhere in the mid-1970s the Finns started to think that there was no way out of the recession by means of increasing government expenditures—by means of traditional Keynesian demand management. They decided that the only way out of that situation is to restore profitability and international competitiveness in the private sector, and to support growth in the private sector, and then to measure government expenditures and taxation in some proportion to the ability of the economy to bear public services and government expenditures. And that was the line that was taken. It was taken by government with the Social Democrats and also the center party. (The conservatives were out.)

If we compare, in contrast, Sweden, the policy quite clearly was that whoever is unemployed will always be employed in the public sector. And Sweden did not have any unemployment throughout the 1970s. The Swedish unemployment rate was 2 percent. But if you look at the structural employment in Sweden, you draw two schedules: employment in the public sector and employment in the private sector.

The private sector employment has been coming down for ten years and the public sector employment is increasing. Many of these jobs in the public sector are in the local governments. And the central government underwrites these expenditures, so the problem translates into an enormous deficit of the central government. The private sector in Sweden has stagnated for ten years. There's been an increase in GNP because every time you hire a person in the public sector we count these wage payments as part of the GNP.



Photos by Craig Terry

Finland, on the other hand, is the only industrial country where the relative size of the public sector has actually declined, and substantially declined, in the 1970s—from some 42% in 1977 to 38 percent today. During the same period, in Sweden, the share of public sector spending increased to 65 percent from some 47 percent in 1970.

And furthermore, the Finnish private sector has been doing extremely well in the past three or four years—without any government support. There's been virtually no government support in any of the crisis industries. In the steel industry there has also been absolutely no support. And yet, the Finnish steel mills are the second most advanced steel plants in the world—right after Japan—and are able to compete with heavily subsidized European steel mills. Paper mills—the most advanced, also in terms of technology, in the world—are much superior to paper mills in European countries.

There are also many, many examples of the individual entrepreneur who knew that he could not build prosperity on the assumption that the government would come in and rescue him because the government simply didn't have the financial means to do so. So the only possibility for him to succeed was to analyze the world economic situation and see how he could succeed in competition in world markets. And these individual examples explain why despite this stagnant growth in the world economy, industrial output in Finland has continued to increase to the extent that from 1970 to 1981, Finland has been the second fastest growing industrial country. Sweden is right there at the bottom with the United Kingdom.

Dramatic changes continue to take place in the world economy. While the emergence of the low cost producers of the third world present a challenge and a threat, at the same time they present a tremendous opportunity. There will be countries that will make use of this opportunity, and those countries will succeed.

E. Littlejohn—Thank you, Mr. Kouri. Well, we've had a good deal of food for thought and we thank the Manhattan Institute for this opportunity. □

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and we regard ourselves as having set the example for America. I think the general perception in Britain is that it has not worked. Now we are looking at Reagan either to show how that experiment went wrong in Britain or to make the same mistakes. The trend in Britain these days is to complain that the Thatcher or Reagan experiment causes too much social anguish. In other words, the social pain of right-wing social policies is not worth the illusory gains which are expected from it. Therefore, the result in Britain is, first of all, that it encourages the extreme left wing in both the regular political parties and the extra-parliamentary parties. Secondly, we have seen the creation of a whole new party to occupy the middle ground, and there is a terrific drift now from both wings to the middle.

MR— But Mrs. Thatcher's actions have been utterly different from her words. She's got a lot of free-market, roll-back-the-government rhetoric, but in fact she has not cut government expenditures. There have also been increases in certain taxes. So Thatcherism is a failure of implementation; it's not a failure of her program because the program has not been implemented.

Bernheim—I think the example of Sweden is very instructive. I once asked the so-called conservative Prime Minister [Thorbjorn Falldin] who followed Olof Palme exactly what he was going to do to turn the welfare state around. I asked, "Are you going to lower government expenditures?" And he said, "Well, no, we can't do that because the Swedes are used to the social services." Then I asked him whether he was going to cut the taxes, and he said, "Absolutely not, because that's what pays for the social services." "Well, then," I asked, "what are you going to do?" And he said sullenly, "We won't go any further." And that's it! That's the problem with trying to change these things; it's not a politically popular move.

Jurgensen—We have exactly the same situation in Germany. If we were to switch from a liberal coalition government to a conservative coalition, they would not risk any drastic reforms in the beginning. But maybe they will risk it in two years, because the economic situation may simply leave no other alternative by then. The thing is, no government will cut back on any social programs unless it is under enormous economic pressure. In Germany, that pressure comes mostly from the outside — from foreign competition. If Germany sees its automobile industry going totally downhill because the economy is overloaded with regulations and taxation, then they will have to do something; there is no miracle anymore.

MR—And that seems to be a good note on which to end this discussion. Thank you all for your comments.

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