

## Sunday Wrap

Greetings from the wonderful cafe at the Enø bakery in Karrebæksminde, the best in Denmark, if you ask me.

I came back here to my roots for a long weekend for family reasons, but it has reminded me – yet again – of the quality of life in big parts of provincial Europe.

So, since I apparently confused some readers last Sunday with my enthusiasm for recent US policy decisions- and my frustration with much of present European policy-making (or, specifically, lack thereof), let me set the record straight.

But first the backdrop: Last Sunday, I discussed the last two years' vast outperformance of the US economy relative to Europe. It's been one of the greatest differences in growth between the two economies in several decades - and it remains huge.

The US outperformance can be explained by, primarily, the difference in shocks (the US enjoyed a small terms-of-trade gain while Europe suffered a massive loss), the difference in fiscal policy (the US delivered a series of huge stimulus packages while the European fiscal impulse has been broadly neutral on average), as well as the generally more flexible US economy, which means that it adopts faster and better to shocks and stimulus.

I argued that the Fed therefore ought to be in no hurry to cut rates (this past week's inflation numbers lend support to that view). In contrast, I argued that the ECB's continued hawkish stance and intentions will unnecessarily hurt the already dismal growth even further. I also discussed the contrast between the fiscal outlook, specifically my concerns about Europe's obsession with fiscal rules rather than putting fiscal muscle and a comprehensive financial sector approach behind the commitment to fight climate change. Not surprisingly, this past week, the European Commission downgraded its forecast for GDP growth in 2024 to 0.8% in the eurozone (from its previous forecast of 1.2%) and for the EU to 0.9% (from 1.3%). In my assessment, both remain too high, given the fiscal and monetary policy stances and the global outlook.

In reaction to my note last Sunday, I received a number of questions on whether I had "surrendered to the superiority of US policy-making", as one writer put it. The short answer to that is – in the big picture department – "absolutely not".

The US may be exceptional, but so is Europe: Not only have the European nations – enemies for centuries – become friends during these past 75+ years, but close allies with shared values. And only in Europe have sovereign states understood the evolving definition of sovereignty in a global world and therefore put in motion economic and political integration with clear benefits to its population. It was no surprise, therefore, that as soon as the Soviet empire crumbled 35 years ago, its client-countries in Central Europe, as well as Western European traditionally neutral countries, flocked to the EU to become part of the European integration process. As a result, more people have now reached higher living standards – in terms of income and quality of life – in Europe than anywhere else in the world.

Of course, I'm not claiming that everything is great for everyone in Europe. Or that the US – or any other part of the world – does not have big segments of their population which enjoy as high, or higher, living standards than segments of Europe. And, needless to say, the present state of affairs may change in the future. But then again, a country, which has once elected Donald Trump president and is now apparently close to doing the same again, surely suffers from some serious issues throughout society.

In my assessment, those issues include the structure of American democracy, including the excessive, and destructive, role of money in US elections as well as the outdated - and bizarre - system of an electoral college, which hands disproportionate power to mostly rural states relative to modern city centers on the coasts. The change in the way the population gets its information has also played an important role. In the US, big parts of the Fourth Estate of democracy – traditional media – have turned into partly partisan opinion providers, while the new Fifth Estate – social media – has become venues for distribution of all sorts of crazy stuff without accountability for the providers. Not surprisingly, in the Economist Intelligence's latest Democracy Index (2023) for "the state of democracy" across the world, the US ranks 29, well behind most of Europe and the rest of the OECD.

But economics, as it has been formed by policy-making over the past four decades or so, has also played a key role. I will summarize where I think it's gone wrong for the US as its now contributing to the considerable risk of another Trump presidency.

First, to be clear, the US is considerably wealthier in per capita GDP terms than Europe. On World Bank data, US per capita GDP is USD 76,000 (2022, latest available data) compared with USD 41,000 in the eurozone, and USD 37,000 in the EU. (The UK is at USD 46,000.)

But these differences must be taken with a grain of salt for at least two reasons:

First, part of the difference can be explained by what appears to be a chronically overvalued US dollar (made possible by the US' so-called "exorbitant privilege" of being the world's reserve currency) and an undervalued euro. If in doubt, consider the constant current account deficit in the US and surplus in Europe. Therefore, measured in PPP terms (still by the World Bank), the eurozone per capita GDP is USD 57,000 and the EU's USD 55,000, i.e., closer to, but still well below, the US level of USD 76,000. The wealthiest Northern European countries have similar per capita GDP levels as the US, measured in PPP terms.

Second, the US suffers from a considerably more skewed income distribution than Europe. In the US, the top 10% of pre-tax earners receive roughly 48% of all income, compared with 37% for the top 10% in Europe. In more technical terms, the Gini coefficient is around 0.45 in the US, but only 0.30-0.35 in most of Western Europe. This means that – roughly calculated – the "bottom 80%" in the US is less well off than the "bottom 80%" in Europe.

In recent decades, the growth rate in per capita GDP has been amazingly similar between the US and Europe (and Japan, by the way), with only three clear exceptions of European underperformance, which I have discussed in previous notes: after the Great Financial Crisis, during and after the European sovereign crisis and during the past two years. The two former periods were pretty clearly the result of European policy mistakes, the latter was the result of the different terms of trade shocks, as well as to the vastly different fiscal approaches in the US and Europe. (When I made the same argument about the different fiscal approaches ten years ago, the standard European pushback was that the "European fiscal prudence" amounted to "short-term pain for long-term gain", while the opposite applied to the US. Today, it seems that Europe is still waiting for those "long-term gains"...) )

Normally, one would have expected the economy with the initially lower per capita income (Europe) to catch up, but that has not been the case. The reason for this is two-fold.

First, it is the result of different choices by Americans vs Europeans. While the annual average number of hours worked in the US declined by less than 10% between 1960 and 2023 (to 1,811 hours worked on average), most European countries saw declines of 20%-30% during the same period: typically to 1,400-1,500, and Germany by 38% to just 1,341 hours worked on average). The rise in European women's participation rate explains part of this because women have chosen to work part time to a greater extent than men. But Europeans' general satisfaction with their lives has also played a role: Europeans simply chose to a much higher degree than Americans to buy this wonderful new commodity called "free time". (A key challenge for European policymakers is to now persuade the population to work more, particularly via a higher retirement age.)

Second, even adjusting for the different number of hours worked, the US has outperformed Europe these past 10-15 years in terms of GDP produced per hour, which is what shows up as the productivity gap. However, because of the vast difference in income distribution, the productivity gap measured as GDP per hour worked is overstating reality. That said, a number of factors, including a significant shortfall in public investment in Europe in this period, have surely contributed to the disappointing European productivity numbers relative to those in the US. Isabel Schnabel discussed these factors in her excellent speech at the European University Institute in Florence this past week. Highly recommended: [From laggard to leader? Closing the euro area's technology gap](#)

Much is occasionally being made of the greater US private sector, and smaller government sector, as being the dynamic drivers of the stronger US growth, but I'm unconvinced, beyond the greater flexibility (due to less regulation) for the US private part of the economy.

Consider this: The most obvious way of measuring the size of the public sector in the economy, versus the private sector, is via the total tax revenue imposed on the economy, i.e. all taxes collected on income and profits, social security contributions, taxes

levied on goods and services, payroll taxes, taxes on ownership of wealth and transfers of properties, etc. On comparable OECD data, the total tax take amounted to 28% of GDP in the US in 2022 (latest available data) compared with 39%-46% in Europe.

Within the major European countries, Germany is at the low end of the range, France at the highest end. In between the two, the total tax take was 43% of GDP in Italy, 42% here in Denmark and 41% in Sweden as well as in, e.g., Greece. (This is all on a cash basis, which means that it's nonsense to argue, as I often hear, that the problem in Southern Europe is the lack of tax collection. I'm not making a claim about efficiency and fairness of tax collection, but only the point that several Southern European countries collect a higher share of GDP in taxes than, e.g., Germany. Some small European countries have lower ratios because of their role as tax havens, but that's a different issue.)

Not surprisingly, you will have noted that the share of government in the economy – measured as the share of tax collection to GDP, i.e., the overall tax burden – among European countries does not correlate with growth and wealth. This only goes to say that it's not the size of government (within reason) that matters for growth and economic prosperity, but what the state does with the money.

Specifically, a well-sized government can foster higher quality of life and social mobility, via, e.g. public investment, education and social services. Hence, given the US's claim to be "the land of opportunity", it's stunning to observe how poorly the US scores on the various indices for social mobility. Such indices consistently rank Northern Europe at the top. The latest has Denmark as the world's most socially mobile economy (thank you very much - I am, myself, a beneficiary of that, if a few years back) and Finland number two. In contrast, the US ranks 27, well behind mostly European countries.

I suspect that this may go some way to explain why Northern Europe consistently tops the annual "happiness indices", also well ahead of the US. Ultimately, happiness is at least partly a function of expectations, so if you are told from early childhood that you can become anything you want – a millionaire or billionaire, a sports star or what have you – and you then grow up to realize that it isn't quite true, happiness may be a tad harder to achieve than for us Northern Europeans who grew up with a less flowery promise of what life may have in stock for us.

When further considering the economic factors which may explain Americans' political drift towards folks with absurdly simplified solutions, like Trump, who promise to "make America great again", to "end the carnage in American cities", etc., it may also be important to consider the stunning disconnect that applies to the US between the otherwise statistically significant correlation between a country's per capita GDP and general quality of life, including life expectancy.

US life expectancy at birth has dropped to an extremely low (for a high income country) of just 76 years, from almost 79 years five years ago. In contrast, life expectancy at birth in Europe has increased by around 2.5 years during the same period, to 82 years in the eurozone and 80 years in the EU as a whole. This seems worth restating: In spite of the US' much higher per capital income, the average child being born in the US today is expected to live a life that's six years (or almost 8%) shorter than if it had been born in the eurozone. This decline in US life expectancy has taken place in spite of the fact that the US spends twice as much as Europe on healthcare, as a share of GDP, at roughly 18% of GDP, versus 8%-10% in Europe - but, as we know, with extremely uneven availability of care in the US.

Part of this conundrum is explained by US's extremely high homicide rate. It's five times higher per capita than in Europe, and impacts disproportionately younger people. One mirror effect of this, in turn, is the US's incarceration rate of about 530 (per 100,000 inhabitants), 5-8 times higher than in Europe. Incidentally, at an estimated cost of USD 74bn annually, keeping America's 1.8 million people in prison adds almost 0.3 (pretty useless) percentage points to annual US GDP growth - unless, of course, you build a counterfactual in which these unfortunate 1.8 million inmates would have been productive members of the work force.

In other words, Trump is right that there is a degree of carnage in American society. But while he is very good at tapping into - and fuel - part of the population's discontent, one thing is clear: He is not the man who can (or will) address it.

Rather, if only we could learn a little more from each other, we could have:

- the US addressing its political nightmare outlook by becoming a little more like Europe, with a public sector which educates its general population better and which provides better social services to engage people more productively (and yes, i.e. a bigger public sector) - while scaling back the role of money in elections,

- and Europe addressing its economic malaise by becoming a little more American, with us all putting in some more hours of work, a greater commitment to public investment, including to fight climate change, to facilitate the tech industry, as well as to defense, and a degree of deregulation (although, please not the type that has contributed to Boeing's recent trouble with safety standards...),

- and if both would legislate a proper accountability for social platforms ....

...we might have the beginning of a new and better North Atlantic alliance to promote democracy and free markets around the world.

Let's hope for the best for the EU elections in June (although they will cause no more than a modest movement in relative power), and for the best for the US elections in November - which will be era-defining, not only for the US and Europe, but for the world.

And with that I have had my fill of Klaus' coffee and pastries. It's time to go for a hike around the island to burn off at least some of it.

Best

Erik

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