Why Do Americans Work More Than Europeans?

By Edward C. Prescott

Last week, The Wall Street Journal published a story describing a new method of measuring a nation's progress—"gross national happiness." Maybe it's because we're nearing the end of an election season, but one hopes that this indicator does not catch on. Of all the promises that candidates find themselves making, and of all the problems they pledge to fix, one shudders at the notion of pledges to make us happier. The mind reels at the thought of the ill-conceived policies that would be concocted if the stated goal were to increase gross national happiness. It's hard enough to make everybody more prosperous, educated and healthy, but imagine if the government was responsible for keeping you in a good mood. And just think about the data problems.

I mention this not to poke fun at the idea of happiness. Indeed, our Constitution, in its elegant wisdom, allows for individuals to pursue happiness. But individual pursuit is far different from the aggregate management of happiness. This point is at the core of how we should think about many government policies, especially tax policy, which is the subject of this essay.

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Let's begin by considering a commonly held view which says that labor supply is not affected by tax rates. This idea holds that labor participation would remain steady when tax rates are either raised or lowered. If you are a policy maker and you subscribe to this, then you can confidently increase marginal tax rates as high as you like to attain the revenues you desire. Not only that, but you can move those tax rates up and down whenever you like and blithely assume that this will have no effect on output.

But economic theory and data have come together to prove this notion wrong, and we have many different laboratories—or countries—in which we can view live experiments. The most useful comparison is between the U.S. and the countries of Europe, because these economies share traits; but the data also hold when we consider other countries (more on those later).

This issue is encapsulated in one question that is currently puzzling policy makers: Why do Americans work so much more than Europeans? The answer is important because it suggests policy proposals that will improve European standards of living (which should give a boost to its gross national happiness, by the way). However, an incorrect answer to that question will result in policies that will only exacerbate Europe's problems and could have implications for other countries that are looking for best practices.

Here's a startling fact: Based on labor market statistics from the Organization for Economic Cooperation and Development, Americans aged 15-64, on a per-person basis, work 50% more than the French. Comparisons between Americans and Germans or Italians are similar. What's going on here? What can possibly account for these large differences in labor supply? It turns out that the answer is not related to cultural differences or institutional factors like unemployment benefits, but that marginal tax rates explain virtually all of this difference. I admit that when I first conducted this analysis I was surprised by this finding, because I fully expected that institutional constraints are playing a bigger role. But this is not the case. (Citations and more complete data can be found in my paper, at www.minneapolisfed.org.)

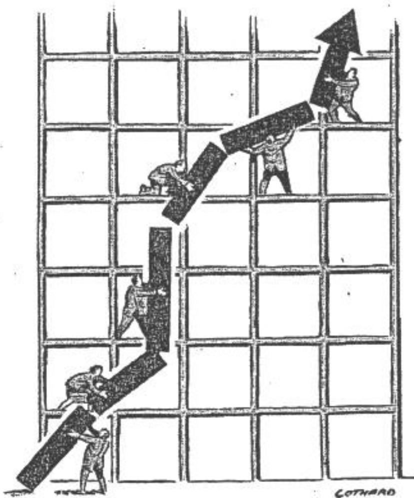
Let's take another look at the data. According to the OECD, from 1970-74 France's labor supply exceeded that of the U.S. Also, a review of other industrialized countries shows that their labor supplies either exceeded or were comparable to the U.S. during this period. Jump ahead two decades and you will find that France's labor supply dropped significantly (as did others), and that some countries improved and stayed in line with the U.S. Controlling for other factors, what stands out in these cross-country comparisons is that when European countries and U.S. tax rates are comparable, labor supplies are comparable.

And this insight doesn't just apply to Western industrialized economies. A review of Japanese and Chilean data reveals the same result. This is an important point because some critics of this analysis have suggested that cultural differences explain the difference between European and American labor supplies. The French, for example, prefer leisure more than do Americans or, on the other side of the coin, that Americans like to work more. This is silliness.

Again, I would point you to the data which show that when the French and others were taxed at rates similar to Americans, they supplied roughly the same amount of labor. Other research has shown that at the aggregate level, where idiosyncratic preference differences are averaged out, people are remarkably similar across countries. Further, a recent study has shown that Germans and Americans spend the same amount of time working, but the proportion of taxable market time vs. nontaxable home work time is different. In other words, Germans work just as much, but more of their work is not captured in the taxable market.

> ***Here's a hint: It's not because of cultural differences.***

I would add another data set for certain countries, especially Italy, and that is nontaxable market time or the underground economy. Many Italians, for example, aren't necessarily working any less than Americans—they are simply not being taxed for some of their labor. Indeed, the Italian government increases its measured output by nearly 25% to capture the output of the underground sector. Change the tax laws and you will notice a change in behavior: These people won't start working more, they will simply engage in more taxable market labor, and will produce more per hour worked.



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This analysis has important implications for policy—and not just for Europeans, but for the U.S. as well. For example, much has been made during this election season about whether the current administration's tax cuts were good or bad for the economy, but that is more a political question than a policy consideration and it misses the point. The real issue is about whether it is better to tweak the economy with short-lived stimulus plans or to establish an efficient tax system with low tax rates that do not change with the political climate.

What does this mean for U.S. tax policy? It means that we should stop focusing our attention on the recent tax cuts and, instead, start thinking about tax rates. And that means that we should roll back the 1993 tax rate increases and re-establish those from the 1986 Tax Reform Act. Just as they did in the late 1980s, and just as they would in Europe, these lower rates would increase the labor supply, output would grow and tax revenues would increase.

Now, might there be a small increase in debt as we move to a better tax system? Sure, but remember that the most important measure of debt is privately owned government debt as a percent of gross national income, which has been flat over the past three years. Also, there is a sure-fire way to handle this increase in debt, and that would be to cut expenditures. Actually, there is another way to handle it, and that would be to pray to the Gods for another high-tech boom and the debt would go "poof," and we'll praise whoever is president for being fiscally responsible.

Some say that the 1993 tax-rate hike was responsible for erasing this country's debt problems because it increased government revenues. This is false. The ratio of U.S. debt to gross national income continued to increase in the years following those rate hikes and did not fall until the fortuitous boom that occurred in the late '90s. The high-tech boom meant that people worked more, output increased, incomes climbed and tax revenues followed suit. You cannot tax your way to that sort of prosperity. Imagine the outcome of the late-'90s boom if tax rates had been lower. And by the way, lower tax rates are good for all taxpayers. We're barking up the wrong tree if we think that "taxing the rich" will solve all our problems. You know who these rich people are? They're often families with two professional wage-earners. If you tax that family too much, one wage-earner will drop out, and that's not only bad for the income of that family but also for the output of the whole economy—and will result in lower tax revenues.

Also, we need to get away from thinking of the rich as some sort of permanent class. Many of the individuals who show up on annual millionaire lists, for example, are people who happened to have a good year and who may never appear on that list again. Consider people who worked hard for many years and built a successful business that finally goes public. The big capital gain they realize that year is really compensation for the uncompensated effort they put into building the business. They should not be penalized for their vision and tenacity. If we establish rules that punish the winners, entrepreneurs will take fewer risks and we will have less innovation, less output, less job growth. The whole economy suffers under such a scenario—not just those few individuals who are taxed at a higher rate. And this doesn't just involve the Googles and Apples and Microsofts, but countless other companies that start small and end up making large contributions to the economy.

The important thing to remember is that the labor supply is not fixed. People, be they European or American, respond to taxes on their income. Just one more example: In 1998, Spain flattened its tax rates in similar fashion to the U.S. rate cuts of 1986, and the Spanish labor supply increased by 12%. In addition, Spanish tax revenues also increased by a few percent.

And that brings us back to our framing question about the labor supplies of the U.S. and Europe: The bottom line is that a thorough analysis of historical data in the U.S. and Europe indicates that, given similar incentives, people make similar choices about labor and leisure. Free European workers from their tax bondage and you will see an increase in gross domestic product (oh, and you might see a pretty significant increase in gross national happiness, too). The same holds true for Americans.

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