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The Economic Performance of Nations:
Prosperity Depends on Dynamism, Dynamism on Institutions

by Edmund S. Phelps[*]

Selecting economic institutions, I will argue, may very well be, in most if not all countries, the most critical area of economic policy making and yet it has been decades since it held center stage. A surface cause is that our understanding of institutions is relatively meager. A deeper reason is that it has been hard even to get started: We cannot have a reasoned discussion of the performance of institutions and the selection among them – which institutions are working well, which must be altered, and which new ones brought in – until we are willing and able to specify (for the sake of argument at any rate) the kind of economy we desire to have. Here I want to propose a conception of the kind of economy that economic policy making would do well to aim for – a notion (if it is not too pretentious to say) of the desirable economy.[1] Such a conception can serve as the moral criterion for choosing among alternative structures of economic institutions. It also serves to put the whole discussion of economic policy in a somewhat new perspective.

The criterion most often used, implicitly or explicitly, in policy discussion is the static efficiency criterion applied in neoclassical economics and utilized in neoliberal/supply-side analyses of economic policy. In this doctrine, the focus is on incentives to work, to save and to invest; and economic policies are judged by their disincentive effects on these decisions. We have all assimilated this neoclassical message, of course, the radical postwar Keynesianism being a thing of the past. We understand that countries *can* cause considerable mischief through misjudged settings of various policy parameters – excessive marginal tax rates, prohibitive replacement ratios, and so forth. The neoclassical/neoliberal/supply-side critique of the continental western European economies, however, goes farther, much farther: It states that, in fact, these *mis-tunings* of policy parameters *are* causing – indeed they are the *main* cause of – the low employment and growth slowdown there. (See Layard, Nickell and Jackman, 1991.[2])

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[1] This abstracts from matters of economic justice. A desirable economic system might be run justly or unjustly from some standpoint but might be more preferable to other systems in either case.

[2] I suggested that market forces were at least as important if not more so, such as the extraordinary elevation of real interest rates in the 1980s (Phelps, 1992) and the slowdown, apparent by the late 1970s, of productivity in Europe and, to a much lesser extent, the U.S. (Hoon and Phelps, 1997).

I do not want to insinuate that this neoclassical analysis is without merit or that it makes no contribution at all to accounting for the relative stagnation still present on the Continent and in Japan. My own work, for that matter, has taken account of the effects of tax rates on labor income, especially the short-run effects.[3] (Phelps, 1994). It has also placed much emphasis, perhaps more than is warranted, on employment and unemployment effects of a bloated level of welfare-state entitlements. (Phelps and Zoega, 1997) By now, a wide range of policy influences on economic activity and on growth have been indicted. (See Heckman,[4] 2004) So, while insisting that any assessment is subject to uncertainty, I agree that *some* appreciable part of the sag in activity and the slowdown in productivity in western continental Europe from the early 1980s onward and in Japan from the early 1990s, results from these and other mis-tunings. The open question is the *degree* of importance of these neoclassical policy shocks. It could be that the estimated part played by escalating welfare entitlements and successive tax hikes in statistical explanations of the rise of unemployment on the Continent in the 1980s and 1990s relative to the United States is *largely* the result of a spurious correlation of those forces with the slowdown of technical progress, unfavorable demographic developments looming in the future and other influences – not all of which are easy to implement in statistical analyses. If we look at the cross section of nations belonging to the OECD we do not find that inter-country differences in unemployment and labor-force participation rates are appreciably explained by differences in the tax rate on labor, the replacement ratio and the size of the public sector.[5]

My complaint is that economic policymaking has gone from seeing neoclassical analysis as having a necessary place to regarding it as sufficient. Efficiency has gone from being an element of the good economy to being the sole criterion. The preponderance of actual and proposed reforms in Europe in the past few years have seldom looked beyond re-adjustments in the fine tuning of the neoclassical instruments: tax rates, social contributions and public expenditures. Believing the inflated welfare state to be the main problem, some countries are planning to retract it a notch, starting with expansions of the contribution time – in Italy, from 35 years to 40. Believing that high tax rates are the problem, some countries plan modest tax cuts – in Germany, tax rates were cut from xx to xx. Believing that the replacement ratio in unemployment benefits to be crucial, some countries plan to cut it back – in France, from xxxx to yyyy per cent.[6] Believing that a shortage of infrastructure is also at fault for Europe's ills, the European Commission plans a program of increased bridges and tunnels – two billion euro's worth within 10 years. It is almost laughable that policy planners would suppose these modest, incremental policy reforms could be sufficient to make a noticeable difference in employment or in productivity growth. The deeper point, however,

[3] Holding constant the other tax rates, such as the rate on non-labor incomes.

[4] In part, Heckman's scrutiny extends to some of the economic institutions that I have been writing about very recently (Phelps, 2003) and will be here.

[5] Perhaps a multiple regression analysis would enable us to tease out some satisfactory results.

[6] These points were independently made in recent columns by me (Phelps, 2003b) and by another observer (Raphael, 2004).

is that these responses show no serious thinking about what constitutes a well-performing economy. So let me give my view on that matter and go on to discuss some preliminary, but suggestive, findings.

The Desirable Economy: High Performance as Productivity and Prosperity

What is wanted in policy discussion is an explicit conception of economic performance – of what a desirable business life is. Clearly, working-age people want a wide range of careers open to them. That in turn requires that wage rates be high in a wide range of jobs, hence a high-productivity economy. (Establishing a generous level of entitlements, such as the demogrants and tuition-free education for all, would permit people to choose the work they like regardless of how low the relative pay is; the difficulty would be that the high-productivity work needed to generate the tax revenues to pay for such entitlements would not generally be chosen.) Another point here is that active-age people need conditions in which they can function: to be able to think, to work and rest, and so forth. These conditions in turn require that people to be able to afford adequate space around them, protection from severe cold and severe heat at home and at work; and affording these things requires high productivity. Nevertheless, high productivity is just one element of good economic performance.

For an economy to be said to be performing well its participants also need to be prospering. Prosperity means the available jobs are engaging and rewarding in more than pecuniary ways. It means the availability of work enlisting the minds of the jobholders, offering challenges in problem solving, leading them to discover some of their talents and causing them to expand their abilities. The personal growth that comes from the discovery and development of talents is basic to what is often called job satisfaction. Clearly this prosperity is an end in itself, not merely an instrument to a high level of economic activity. Yet, job satisfaction has knock-on effects such as promoting high participation in the labor force; also, a high level of employee morale, or loyalty, serves to lower unemployment and thus add to the availability of such good jobs. So the degree of prosperity may be rather well *proxied* by some relatively well-measured things like the level of business activity – the participation rate (L/P), the unemployment rate ((L- N)/L) and the activity rate (N/P).

If that is our conception of a good business life – problem-solving and discovery of talents, which in turn rest on the economy's dynamism, it is hard to see why the neoclassical preoccupations with disincentives should be accorded center stage. Correcting the calibrations of tax rates, social contributions and public expenditures will not make resources more productive. And it will not make jobs more engaging and more rewarding. That is basically why the plan to add to the stock of bridges and tunnels strikes us as a sort of joke, even if we cannot put our finger right away on why it is funny. It seems unlikely that more bridges and tunnels on the Continent will contribute measurably to the sense of prosperity that those countries are so acutely and visibly missing.

Is it the generally accepted conception of high performance, though? In Europe? Or anywhere? The notion of high economic performance, of the desirable economy, that I have just outlined is commonly said to be peculiar to the United States.[7] Probably many readers will feel that this notion of performance – more broadly, the elevation of work and business – does resonate in varying degrees and respects with some memorable American writers, among them Franklin, Emerson, Lincoln, William James, John Dewey, John Rawls, Richard Rorty and Derek Curtis Bok.[8] Nevertheless, the commonly held impression that this conception of high performance is foreign to European values is unfounded. Quite the contrary.

The humanist thesis that discovery, independence, enterprise and participation are the route to personal development and achievement was, after all, first articulated and developed by Europeans. This humanism grew out of ancient Greece, the Renaissance and the Enlightenment. Aristotle, in the *Nicomachean Ethics*, starts from the premise that "all men desire knowledge" and goes on to discuss the relations among work, learning, development, enjoyment and happiness. Cellini in his *Autobiography* is the prototype of the liberated individualist bent on accomplishment and succcess. Smith propounds the social value of self-help and competition, and he champions broad participation in such a business life. Say extols entrepreneurs as constantly reinventing the economy in their quest for higher yields and Condorcet elevates the productivity of these economic entrepreneurs over the zero-sum results of political entrepreneurs vying for political favor.[9] Evidently American values derive from this European thought. And this line of thought goes on beyond the 18th century. In later centuries, Henri Bergson sees the potential for change as the *elan vital* and the good life as one of constant "becoming" rather than mere "being." Marshall dwells on the workplace as the source of most of people's mental activity and Myrdal views jobs as soon to be a richer source of most people's satisfaction than their consumption.

Why, then, is it rather widely surmised that Europeans revolted long ago against these core Western values? Such a revolt is inferred from the fact that, in the early decades of the 20th century, much of Continent turned away from the vibrant capitalism of 1913: eastern Europe choose communism, later market socialism, while two western European nations, Italy and Spain, invented and installed corporatism. But a majority of the proponents of each of these counter-movements supported it on the argument that this system was *superior* to capitalism in its ability to generate investment and harness science for progress, thus economic growth, and superior also in the offering jobs that engaged the

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[7] This was remarked (in passing) in a comment at the conference by Ralph Gomory. At the time I did not disagree, if I remember correctly. But I am begging to differ somewhat now.

[8] During his American years (at Harvard, where he is again) Amartya Sen distilled much of this literature, making "doing things" and "capabilities" central to freedom and justice.

[9] See p. 33 in Rothschild (2001), a book in which Condorcet is prominent.

mind and enlarged the responsibilities of the worker. The suggestion that the humanist tradition is foreign to European values and unique to American ones is therefore not historical and much exaggerated.

What is sometimes suggested, however, is that there has been a considerable erosion in the influence of these values on the behavior of typical Europeans. In Europe, the observation goes, people work to live and in America people live to work. It is suggested that that more than a century of anti-business sentiment, some of it the result of Christian teaching, some of it an exasperation with fluctuations and inequality, has weakened the force of the old Western values.[10] The questions raised here have all the makings of a great debate. What is it that is the main source of the prosperity deriving from a nation's economy? Is it certain economic institutions – the presence of some and the avoidance of others? Or is it culture? Or what? Or is it maybe a vast panorama of things? But before we can even touch on that subject we need to take some further steps.

Prosperity Depends on an Economy's Dynamism, Maybe Productivity Too

What must be present for an economy to offer this prosperity, which is so important an element of high performance? At one level, I would say the answer is that there must be *productive change*, which I call "dynamism." First, for the employed to be prospering there must be the stimulus and challenge of change going on in the workplace – hence new problems to be solved, new tasks to be mastered, new abilities to strive for. Second, and less obviously, a country does not want misguided or pointless change; it wants investments that appear to the financial sector to have good prospects of creating productive change, that is, gains in productivity.

Is there any empirical support for that thesis? In the late 1990s I realized there was circumstantial evidence unfolding that some countries had lower levels of dynamism than others and that the countries inferred to have low dynamism showed signs of poor economic performance – low prosperity, in particular, whether or not also low productivity. When the internet and communications revolution broke out, some nations went into an investment boom and some were barely responsive. Of the 12 large OECD economies, three looked to be low in dynamism: Germany and Italy missed the investment boom and France was very late to it. I realized that these same three economies had also been showing signs of poor rewards in the workplace and poor morale as a result (relative to the other 9 economies): these signs included low labor-force participation and high unemployment.

[10] Americans were not as exposed to an anti-materialist strain in some Christian teaching, were not racked by wars to the degree the Europeans were, and less inclined to see inequality as disequalifying when economic growth appeared to promise so much. I don't know whether these stabs at an explanation are convincing. (Europe was similarly cut off from America's pragmatist school of philosophy, 1880 to 1930.)

Does the productivity, the other element of performance, also depend on dynamism? Here the evidence is mixed, to say the least. The fact that an the UK economy shows significant responsiveness at least occasionally to market opportunities, which is a sign of some dynamism, and yet appears to have relatively low productivity next to the levels in France and Germany, which show relatively little sign of dynamism, may be an indication that relatively high dynamism is not sufficient for relatively high productivity. (The other possibility, of course, is that the data of the late 1990s have misled me into grouping the UK among the economies with relatively high dynamism. Gordon Brown, Chancellor of the Exchequer in Britain, remarked that Britain did not have a boom in the late 1990s, contrary to my calculation.)

The fact that both France and Germany have relatively high productivity in the set of 12 large OECD countries I have twice referred to may indicate that relatively high responsiveness, thus relatively high dynamism, is not *necessary* for relatively high productivity. A familiar characterization of Europe, after all, is that it owes its high productivity to its clever imitation of what is proven to work in the US after the heavy costs of innovation and the frequent experience of failure. In fact, when some rough allowance is made for the rather poor rates of inclusion of various disadvantaged workers from jobs in the French economy, it is not at all clear that France does rank relatively high in productivity. In any case, this whole matter has to be left to future research.

An Economy's Dynamism Depends on its Economic Institutions

How is a country to generate this dynamism on which prosperity depends? My thesis in this connection is that the degree of dynamism in a nation's economy hinges on its development of some key economic institutions – company law and corporate governance, the population's preparation for business life, the development of financial instruments such as the stock market and so forth. Such general institutions as the rule of law and provision of enough personal and national security to safeguard earning, saving and investing are needed for any market economy, even market socialism; they are insufficient for dynamism. To say that is in no way to depreciate the pioneering work of Douglass North bringing out the paralysis of an economy not supported by property rights; neither is it to depreciate the imaginative research by Andrei Shleifer confirming the large explanatory power enjoyed by some of the property rights he studies. It is only to say that there is more to dynamism than what North introduced and Shleifer tested and reinforced. The North-Shleifer thesis is based on classical considerations and my additions are modernist, resting on actors' imperfect knowledge. The contrast between ballet traditions drawn by Twyla Tharp applies here: "Modern is classical plus more."

Evidence exists for this thesis on sources of dynamism too. We could have predicted very well (even as early as 1990) the ranking of the 12 large countries by the strength of their booms, if any – thus how they were going to rank over the late 1990s in terms of the dynamism they are inferred to have – simply from knowing how they ranked (in 1988 or 1990, say) by the percentage of the population with a university degree, the OECD index of licenses required for opening new businesses and the breadth of the stock exchange as proxied by the market value of the shares outstanding (relative to GDP).

The two pieces of evidence I have brought up, the first linking circumstantial evidence of prosperity to the quality I have called dynamism and the second piece positively linking dynamism in turn to some institutions, e.g., a broad stock market, and negatively linking dynamism to some other institutions, e.g., licensing requirements on new firms, is, I think, a modest but significant advance. I would stress two tenative conclusions from this kind of analysis. First, there is considerably more to dynamism, it appears, than private property. Second, unemployment is not entirely or mainly the effect of misguided labor-market legislation. However, needless to say, this fragmentary evidence cannot speak to the whole wide range of issues over reform now facing Europe.

Is there evidence *directly* associating high performance – that is, prosperity and its visible sign, high employment, and high productivity – with the presence of institutions believed helpful to dynamism and the absence of those believed harmful? Such evidence emerges even with the small sample of just 12 large OECD economies.

An informal cross-country analysis of those economies that I have conducted with Gylfi Zoega examined three measures of economic performance: the employment rate (relative to the working-age population), the unemployment rate (relative to labor force), and labor productivity – the first two of these measures being observable proxies for job satisfaction, personal development for work, etc. Taking one institution at a time, we found that university education improves all three measures of economic performance: employment, unemployment and productivity too. Another institution, the "red tape" impeding innovators, as measured by the OECD index of barriers to entrepreneurs, is bad for all three elements of performance. Finally, legislation providing a high level of job protection is bad for productivity but does not have a clear effect on either employment rate or unemployment rate.[11]

Searching for Effects of European Corporatism

As everyone knows, a system often called "corporatism" took shape in the interwar period, specifically from 1925 to 1940, in parts of continental Europe, South America and East Asia. The fundamental corporatist idea was to retain the private income, private wealth and private ownership of firms

[11] Some of these results are displayed in scatter plots in a commentary (Comment II) appearing in Phelps (2003a).

that was so central to capitalism (and found in avant-garde examples of market socialism too) but to remove the brain of capitalism – to curtail and to modify the mechanism of experiments and discoveries undertaken by unorganized entrepreneurs and financiers on which capitalism relied upon for its direction(s) – and to replace it with a selection mechanism governing investment and innovation that would require a consensus of key social groups. The main allocative decisions, such as the start-up of a firm or its close, is to have the approval of the designated groups constituting the society. Corporatism sought to interpose the interests of the whole society in a range of decisions affecting the directions taken in the business sector. The visible structure of this economic system, whatever the main uses to which it was actually put in this or that country, had several prominent features – nearly comprehensive labor unions, employer confederations, and big banks. In the postwar period, workers councils became another distinctive feature of the Continental system.[12] And a new rhetoric grew up around these Continental systems that introduced such terms as "social partners," indicative planning, "co-determination" and *concertazione*.

As was mentioned in passing above, proponents and designers of the new system generally claimed it was inherently superior, at least in the sense of potentially preferable, to the capitalist systems then operating because it made possible a more rational resource allocation through the opportunities it offered for coordination in wage setting, investment decisions and so forth. Corporatist theoreticians no less than socialist theoreticians saw it as an ex ante advantage of their system that it would or could be an instrument for scientific management of the economy. The contrary view that began to arise in the 1980s held that corporatism, in setting up machinery to facilitate direct interventions over a wide swath of economic decision making, ended up giving one or more interest groups a power to veto every proposal for progress unless and until a satisfactory bribe was paid.[13] And these powerful groups were not the Rawlsian least-advantaged and seldom if ever represented by far-seeing and selfless statesmen.

I have inclined to the hypothesis that corporatist systems are harmful on balance for both productivity and prosperity – all things considered.[14] As I and some others see it, the peculiar corporatist institutions, to the extent they are still present in some Continental economies, do not necessarily block *imitation* of known and uncontroversial advances in other economies – witness the Continental "catch up" in the postwar decades. But, it appears to me, the

[12] A striking fact uncovered by Rajan and Zingales (2002) is that in most countries of Continental Europe stock market capitalization as a ratio to GDP had by 1980 still not recovered to the zenith reached in 1913.

[13] Two of the pioneers were Herbert Giersch and the late Ezio Tarantelli. The former wrote as if the medieval guilds were still operative in the West Germany. (Giersch, 1993). The latter described the workings of corporatism and built the first index of corporatism (Tarantelli, 1986).

[14] My first efforts were in a book (Phelps, 2002a) with a focus on Italy; my latest effort is a lecture given at Chatham House (Phelps, 2003c).

corporatist institutions and the corporatist mind-set that motivated their establishment do operate to inhibit indigenous *innovation*. In this hypothesis, to the extent that a Continental nation retains vestiges of corporatist institutions and thinking, these causal influences may appreciably account – more than the nation's welfare state – for the alienation from business, the dearth of innovations, and therefore the apparently low levels of job satisfaction, the low participation and the generally high unemployment rates that have become familiar on the Continent.

Of course, what was left of the corporatist structure in this or that Continental economy may in many cases have experienced further changes over the second half of the century. So not only is there the difficult task of weighing the ill-effects of corporatism against the possible good effect. There is also the question is the extent to which the avowedly corporatist countries of decades past have moved away – for good or ill – from their corporatist mode of operation and corporatist mode of thinking.

Some tentative findings from elementary statistical analyses of the data on the 12 large OECD countries are interesting, I think. Gylfi Zoega and I found that, among the 12 large OECD nations, a high degree of corporatism – as commonly measured by the degree of "coordination" among labour unions and among employers – is loosely associated with low employment and low productivity. This much is rather widely granted, with Sweden being something of an exception, or "outlier." That finding is just a simple correlation analysis of the 12 data points.[15] When we allow one or two other institutions to enter simultaneously into the analysis – a multiple regression analysis – the picture changes. The OECD index of red tape obstructing entrepreneurs explains the poorer performance of some of the countries. And employment protection legislation is another institution helping to explain differences between the good performers and the poor performers. But these two institutions, red tape and job protection, are themselves rather strongly correlated with corporatism as measured by the coordination variable. As a result, when these two institutions, which can be viewed as primary effects of corporatism, are included in the analysis, there are no remaining differences for the coordination variable to explain. The coordination of labour unions and employers does not directly exert a negative effect on economic performance. The harms from corporatism apparently come more from the ancillary institutions that corporatist thinking inspires rather than from coordination per se. It is even possible that, with further analysis, the degree of union and employer coordination will be found to be a small "plus," *given* the other institutions, some of which may have a strong corporatist flavor.

It is possible, therefore, that the early theoreticians of corporatism were not wrong in claiming a beneficial potential in the brave new system. However, it is

[15] Some scatter plots illustrating some of these propositions are shown in Phelps (2003a).

beginning to appear quite likely that the overall impact of the corporatist system and corporatist mind-set have done great harm to Europe's dynamism and, in turn, to its economic performance.

Does Culture Play a Part in Economic Performance?

With Continental Europe still languishing more than two decades after the onslaught of shocks felt in the 1970s and early 1980s and with India, China and parts of southeast Asia showing enormous energy and initiative, whatever the support and the impediments their economic institutions are bringing, it is not unreasonable that economists and non-economists should begin to speculate that some as yet undetermined *part* of the conspicuous inter-country differences in current-day participation, investment and so forth may stem from something causal influence *other than* the neoclassical policy differences and the economic institutions just discussed: Perhaps differences in culture are an important influence on economic performance.

Recently I wondered aloud whether the Continent's culture must share the blame with some of its economic institutions for its economic problem – its dearth of prosperity and its less than first-place level of productivity.[16] Several points sprang to mind. There is European's own expressed uneasiness about making money. As Hans Werner Sinn said to me, a German would rather say that he inherited his wealth than to say that he had made his fortune. There is also the practice of shielding teenagers from any sort of job experience or earning any money, so that the business world must seem rather foreign to them as they are growing up. It is widely suggested that European schooling drains children there of some of their playfulness and creativity. There is the point that the protection of European culture effectively means protecting the older and more established people, which may cause young people to believe it is wrong to compete and risk upsetting the established order. I might add that I did not suggest that Europeans are deficient in some sort of genetic material. (After all, the Americans are largely of European stock.)

These speculations are interesting to me and apparently to nearly everyone. The question Is it economic institutions or culture? – would make for an almost irresistible debate. Yet speculations such as these are met with some ambivalence by those economists who think, very plausibly, that economists should specialize in finding causes in the areas in which they have expertise, not in areas already heavily populated by psychologists and sociologists. And Europeans themselves are rather sensitive to suggestions that their culture, which is one of the things of which they are most proud, might play a part in their relatively poor economic performance.

[16] See a lecture given in Munich (Phelps, 2002b) and a newspaper column published rather widely in Europe (Phelps, 2002c).

My research strategy continues to be one focusing not on culture but on economic institutions, such as those I have mentioned above and some others. This is presumably the strategy in which economists have a comparative advantage. We will see to what extent we can explain in the statistical sense the differences in (proxies for) economic performance among European countries and between the Continent on the one hand and, on the other, the United States and other salient comparators. Perhaps this venture will fail for the very reason that culture is the greater determinant of the degree of dynamism and thus economic performance. Or, almost as bad, we may find that institution choices by countries appear to be the cause of differences in economic performance but these institutional differences across countries are mere reflections of differences in culture whose primary influence is direct, not through institutions.

But this seems to me to be assuming what is to be proved. Maybe culture has no independent influence that will defeat or invalidate such an analysis. It could be that when the institutions are right, jobs are engaging, business is exciting and the culture evolves to recognize and reinforce the gratifications of a healthy business life. Where the economic institutions are receptive and conducive, the "entreprenurial spirit" comes to life.

The challenge presented by a rival cause, culture, is not the only challenge that this institutional research faces. It has been suggested that institutions lack the sort of exogeneity that would qualify them to be causal forces in the etiology of healthy and sick economies. My reply is that countries have little idea of what is the best set of economic institutions for them. Rats, psychologists say, look around to see how other rats do after eating suspicious foods. No doubt, countries also try to engage in such "social learning," sometimes adopting an institution because it is presumed to be good choice in view of the satisfactory performance estimated to be obtained in some other countries that adopted the same institution.

But, obviously, when institutions are manifold and connected in networks, such inferences are highly uncertain. To me there seems to be an enormous amount of arbitrariness in each country's network of institutions. (Of course, if all Continental economies simply copy one another's institutions, statistical analysis cannot proceed, even if the chosen set of institutions is exogenous to the whole sample of countries. However, that is a different proposition.)

Another objection, which is best faced right now, starts from the contrary premise that institutions do *not* change from one decade or even milieu to the next and yet, very typically, a country has a golden age at one time and tough sledding in another. (Maybe a country's set of institutions has evolved in such a way as to be good on the average, so it looks good in one era and looks bad in another.) This objection observes that the Continent's rapid growth and high employment were the envy of the world in the postwar decades – only a few decades ago, when the Continent had much the same economic institutions as now. It is a mistake, therefore, to infer that Continental institutions are at fault now for the difficulties in which most of the large Continental economies have found themselves in the past twenty years.

But, obviously or not, this argument must first establish that the institutions on the Continent during the “glorious years” from the mid-1950s to the mid-1970s were indeed good. And that is not established. To rush to the inference that the Continent’s institutions were good in those years would be to overlook the unusual market forces operating in that period. After the rubble of the war-torn countries was finally cleared away and the bricks and tracks all put back together, the Continent found itself with a one-time opportunity to catch up with the technical progress that it taken place in the American economy (and, later, a sector of the Japanese economy). The fact that the Continent’s set of economic institutions was not obstructive enough to block the extensive – though part-way – catch-up in that extraordinary situation, with its low-hanging fruit ready to be plucked at low cost, does not disprove that some of the Continent’s economic institutions are unfavorable to dynamism, as hypothesized here. Institutions that are good enough for imitation and part-way catch-up (starting from a yawning gap) may not be good enough to generate a creative business sector of considerable and well-chosen indigenous innovation. The logical slip in the objection is that it mistakes the rapid growth rate and ensuing rise of employment to record levels in the glorious years with an economy *structured* for high economic performance in normal as well as unusually opportune times. (Of course, such a structure does not deliver unfluctuating growth and employment.)

A similar rebuttal applies to a mistaken analysis of China. The fact that China’s present set of economic institutions is not so obstructive as to block the extensive – though part-way – catch-up with the West now seemingly underway does not suggest that those institutions could even begin to support an economy of dynamism in China were the low-hanging fruit of technology transfer and partnerships with foreign corporations not present. To say this, though, is not to deny that China has in fact fashioned some new institutions peculiar to China to facilitate catch-up with the West. It has invented new ways of achieving entrepreneurialism. So the Chinese institutions are a hugely interesting case to study.

In sum, I see no compelling reason to be so pessimistic as not to try to understand the influence on various economies of their prevailing economic institutions. Possibly we do well to take as largely or appreciably exogenous each country’s set of economic institutions – many of which are historical accidents and in no way optimal even if deliberately chosen. And possibly we do well not to be deterred by leaps of inference about sui generis episodes that may be total misreadings. It could be that we are quite right to hypothesize that the stock of institutions is the primary cause – or at any rate a primary cause – of the degree of dynamism and consequent economic performance of nations.

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