European corporatism must embrace change

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Why did the economies of continental Europe fail to converge on the US after their brilliant post-second world war resurgence and then, more recently, start falling behind again (see charts)? Why are they mired in high unemployment? What do these facts tell us about their economic model? Last year's Nobel laureate, Edmund (Ned) Phelps of Columbia University responds by arguing that continentals have chosen the wrong system: corporatism.

As Prof Phelps noted in his Nobel lecture, he starts from a rejection of orthodox neoclassical economics.* This, he insists, abstracted from the "distinctive character of the modern economy – the endemic uncertainty, ambiguity, diversity of belief, specialisation of knowledge and problem solving".

A central distinction, argues Prof Phelps, is between capitalism and corporatism. By capitalism, he means a system of free enterprise that embraces and motivates entrepreneurship. **By corporatism, he means a system in which businesses have to negotiate change with the government and "social partners"**.**

Capitalism does not mean laissez faire, argues Prof Phelps, just as corporatism does not mean an absence of private ownership. The difference lies in the openness of the former to economic experiment and so to the gales of Joseph Schumpeter's creative destruction. The new entrants nurtured by a dynamic free enterprise economy are the catalysts of innovation. But the incumbents protected by corporatism are too heavily invested in the status quo: they are prisoners of the present.

The US, as it has been since the late-19th century, remains the world's frontier of market-led innovation. Well-organised corporatist economies, suggests Prof Phelps, can catch up on the progress made by such a dynamic capitalist economy, but cannot surpass it, because they are parasitic upon the latter's vitality.

According to Prof Phelps, the size of the initial gap explains the extraordinary growth in continental Europe in the 1950s and 1960s: in 1950, Germany's gross domestic product per head at purchasing power parity was less than half US levels. Europe, long industrialised, was better equipped for such catch-up than anywhere else in the world (with the exception of Japan). But continental economies were ill-suited to striking out on innovative paths of their own.

Prof Phelps explains not only the rapid rise in relative productivity of the 1950s and 1960s in this way, but also the high continental employment of that period. Faster expected growth of productivity increased the value of capital assets, including trained employees, he argues. This induced an investment boom and so a fall in unemployment. When expected productivity growth fell once more, employment was bound to fall, too, as indeed it did from the mid-1970s.

By the early 1990s, continental output per hour was about 90 per cent of US levels. But only 75 per cent of those of working age in France and Italy were in employment, against 87 per cent in the US. Then productivity growth slowed still further in the eurozone, with hourly productivity in the business sector growing at only 0.9 per cent a year after 1998.

Meanwhile, US productivity growth accelerated. The explanation for this has been a wave of innovation focused on the development and use of information technology, particularly the internet. But continental Europe has shown a lack of fundamental innovation in this sector, compared with the US, and even an inability to use what has been developed elsewhere.

Remarkably, the information technology revolution is the first since the industrial revolution in which none of the big European economies plays a leading role. For this, argues Prof Phelps provocatively, the explanation is a lack of underlying dynamism: "The shortcoming of the system was the continent's corporatist economic system (or systems), a system constructed of big unions, big employer confederations and big banks, all mediated by a big public sector – a system that had been built up starting in the 1920s on the belief that it would be better than capitalism."

This fascinating analysis raises a number of big questions.

The first is what exactly are the distinctions between countries. To answer this, Prof Phelps looked at cultural factors, using data drawn from the University of Michigan's World Values Surveys, **in a paper presented last year in Venice**.***

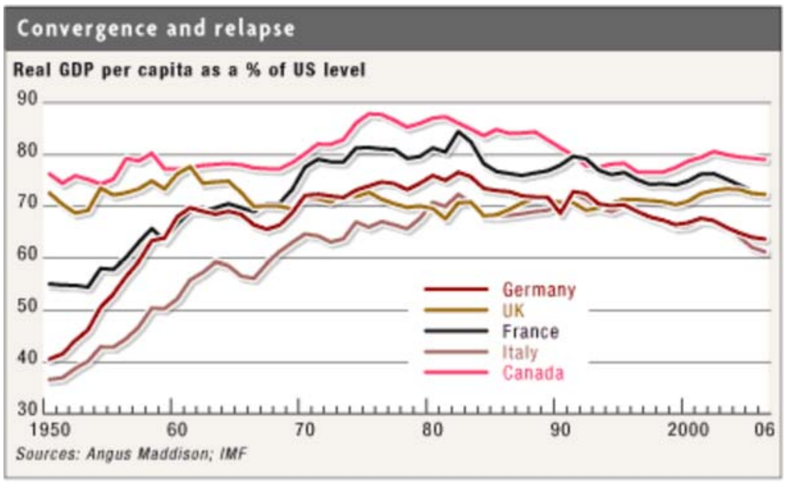
In this paper he contrasted Canada, the UK and the US with Germany, France and Italy. The first group all have superior jobs performance. This, argues Prof Phelps, is partly because of their greater freedom of decision-making at work and so the greater satisfaction people derive from their jobs (see charts). In this way, invisible cultural differences influence the visible outcomes in employment. The US and Canada also have a higher turnover of companies than the continental countries, which is a good measure of dynamism.

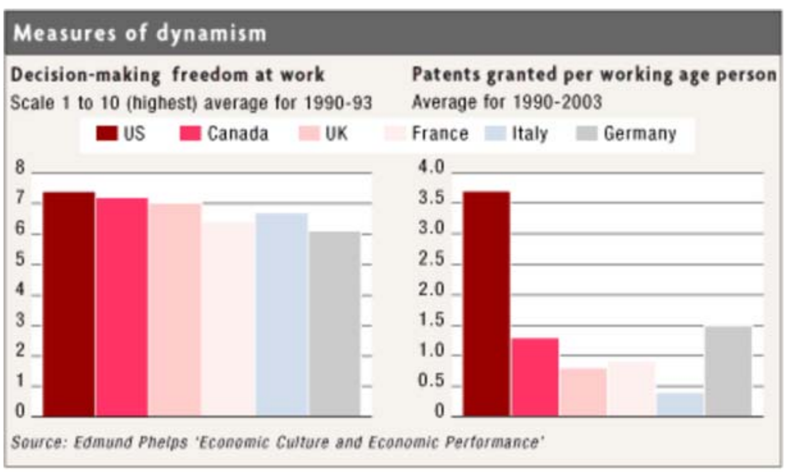
Yet neither Canada nor the UK is superior to the continentals in output per hour or patenting activity. Thus, while differences do exist between the English-speaking countries as a group and the continentals as a group, the US is unique. It is the “capitalist” country: the engine of the future.

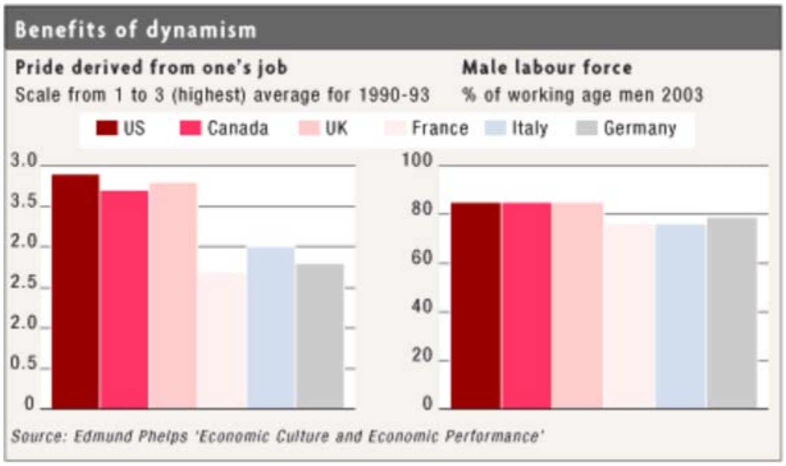
The second question is why such differences should exist. Prof Phelps suggests that the durability of continental corporatism derives from culturally embedded hostility to the rewards of business life.

The final and most important question is what this unorthodox analysis implies for policy.

Here Prof Phelps offers bad news and good news for continental countries. The bad news is that a system delivering neither dynamism nor high employment is failing. The good news is that Prof Phelps believes it is possible to combine dynamism with desired “social inclusion”, provided the welfare state subsidises employment, not idleness. He does not simplistically recommend low taxes and an end to the welfare state. His focus is, instead, on a willingness to embrace market-led change. His advice is good: those who resist economic change will surely be overwhelmed by it, in the end.







** Macroeconomics for a Modern Economy, December 8 2006; ** Understanding the Great Changes in the World, Capitalism and Society, 2006; *** Economic Culture and Economic Performance: What Light is Shed on the Continent's Problem? Conference on the Performance of the Continent's Economies organised by Munich's CESifo and Columbia University's Center on Capitalism and Society, June 2006*.

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