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## The Continent's High Unemployment: Possible Institutional Causes and Some Evidence

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Why is joblessness so relatively high in continental western Europe – the French and Italian unemployment rates 3 points higher than the United States rate and the rate in western Germany nearly 4 points higher than that in the United Kingdom?<sup>1</sup> How can this be explained when in the 1960s and even the 1970s joblessness on the Continent was markedly below that in the U.S. and below that in the U. K. as well?<sup>2</sup> In those years many economists inferred that in its deep parameters the Continent's "model" had a hidden advantage over those two exemplars (relatively speaking) of capitalism and Anglo-Saxon culture.

That is the double-barreled question of this conference and, in any case, it is my question here. Our answer is apt to shape our view of the remedy.

In addressing the question I propose a broader perspective than I took in my earlier research. I believe that to understand the *inter-country differences* in unemployment as fully and deeply as possible we economists have to widen our view beyond structural *shifts* and structural *swings* – beyond those market forces and policy parameters that have gone up or down, which were natural to focus on

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<sup>1</sup> In the latest data, the US rate is between 5.7 and 5.9 per cent, the UK rate 5.2; but the west German rate is close to 8 per cent, the French and Italian rates at or above 9.

<sup>2</sup> In the 1960s, the jobless rate in West Germany averaged 0.7 per cent, in France 1.7, while in the U.S. it averaged 4.7, in the U.K. 2.6. By 1979, the Continent still held its lead: the rate had risen about 2 points in West Germany, about 3 in France; yet the U.S. rate had also risen about 2 points and the U.K. rate also by about 3; and Italy's rate had risen hardly at all.

when the question was the causes of the *changes* in the unemployment rate.<sup>3</sup> We must consider causal forces that have changed little or not at all in recent decades.

To generate such candidates to help explain high relative unemployment I have taken a somewhat holistic approach to economic performance, of which employment is a part. My thought is that the main causal forces behind unemployment differences, thus the relatively high joblessness in much of continental Europe, are forces having systemic ill-effects on economic performance in general: on productivity, the rewards of work, participation rates and so forth. For example, stifled entrepreneurship or an unsuitable financial sector might cause low productivity or low job satisfaction, which in turn might worsen employee conduct or loyalty and in so doing push up the natural, or equilibrium, path of unemployment. So my approach is to seek sources of high unemployment from among various suspected contributors to low performance in general.<sup>4</sup>

To begin I review very briefly the newly developed economics of *swings* and *shifts* in the natural rate in order to defend my claim that this work has not helped us much to understand *differences* in unemployment.

### **The 1990s Theory: What it Did and Didn't Do**

The macro paradigm built in the 1990s, a nonmonetary theory of equilibrium unemployment *paths*, focused on fluctuations in structural forces rather than in the “effective demand” and “effective supply” of monetary models. Developing the

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<sup>3</sup> A clear example of that line of work is my own *Structural Slumps: The Modern Equilibrium Theory of Unemployment, Interest and Assets*, Cambridge, Mass., Harvard University Press, 1994. See also my subsequent papers.

<sup>4</sup> Such explanatory forces would have some tendency to make one country a better (or worse) performer in all dimensions than another country. For possible evidence of such an effect see

1990s theory meant drawing back from the steps taken in the 1980s under the banner of hysteresis. The idea of hysteresis in my 1972 book was that if the aggregate demand schedule suffers a temporary drop, those who become unemployed will be losing their skills and that will tend to retard their reemployment; so joblessness will be found elevated even after demand fully recovers.<sup>5</sup> The idea was taken to extreme in the 1980s with the strong hypothesis that those losing their jobs with such a demand shock will, absent a positive demand shock, never regain employment<sup>6</sup> – at least in a European setting. Later statistical studies confirmed high *persistence* in the unemployment rate, which lent support to the basic idea – that some job losers may become employable only at lower real wages with attendant adjustment difficulties; however, to some extent it simply reflects rising marginal hiring costs, so employment cannot *jump* from one quasi-steady-state level to another.<sup>7</sup> In the end, studies testing the 1980s hypothesis of a unit root, one study by Marco Bianchi and Gylfi Zoega, the other by David Papell, pretty decisively rejected the strong hysteresis thesis: mean reversion is found.<sup>8</sup> There is no support for the view that the relatively high-unemployment

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Edmund Phelps, “European Myths, European Realities,” Project Syndicate, November 2002.

Trans., “Der Mythos vom starken Europa,” *Süddeutsche Zeitung*, Monday, December 9, 2002.

<sup>5</sup> Phelps, *Inflation Policy and Unemployment Theory*, New York, W. W. Norton and Co., 1972.

<sup>6</sup> Olivier Blanchard and Lawrence Summers, “Hysteresis and the European Unemployment Problem,” *NBER Macroeconomics Annual*, ed., Stanley Fischer, 15-78, Cambridge, Mass., MIT Press, 1986; Assar Lindbeck and Dennis J. Snower, *The Insider-Outsider Theory of Employment and Unemployment*, Cambridge, Mass., MIT Press, 1988.

<sup>7</sup> For example, *Structural Slumps*.

<sup>8</sup> See Marco Bianchi and Gylfi Zoega, “Unemployment persistence: does the size of the shock matter?,” *Journal of Applied Econometrics*, 1997; David H. Papell, Christian J. Murray and Hala Ghiblawi, “The Structure of Unemployment,” *Review of Economics and Statistics*, 82, May 2000, 309-315. See also Rune Aberg, “Equilibrium unemployment, search behavior and unemployment persistency,” ms., Umea University, March 2000. They conclude that the equilibrium path itself – the natural rate path, so to speak – is occasionally disturbed by a large and sudden structural shift

countries are mainly victims of relatively bad aggregate demand shocks decades ago.

The 1990s work on the role of *structural* forces as the drivers of the swings or shifts in unemployment began with a fascination for two single-cause “explanations.” Neither proved remotely sufficient, though. One, the supply-side explanation, was that unemployment rose in continental Europe between the 1970s and the second half of the 1980s mainly as a result of rises in the taxation of wage incomes; unemployment rose less in the U.S. because income tax rates there generally rose less or not at all. But a scatter diagram presented by Phelps and Zoega showed little relationship between the rise of the unemployment rate among OECD economies over a 3-decade span and the rise in the tax rate on labor: the fit was not good and the slope unimpressive.<sup>9</sup> True, statistical findings of mine and of others support the premise that an increase in the labor tax rate raises the unemployment rate, other things equal.<sup>10</sup> The reconciliation is that a proportional tax rate on labor income can be theoretically neutral in the *long run*. In my models and some others, if labor taxes are raised to finance increased government purchases (and they don’t impact on agents’ preferences), which shifts down the demand-wage curve, the resulting cut in paychecks and jobs causes household wealth accumulation to slow, which gradually pulls down the wage curve; that decline may finally counter-balance the fall of the demand-wage, putting

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bringing a new mean level of the unemployment rate. (In my view, that path is displaced every day by one or more permanent non-stationary shocks.)

<sup>9</sup> Phelps and Gylfi Zoega, “Natural rate theory and OECD unemployment,” *Economic Journal*, 108, May 1998, 782-801.

unemployment back where it started.<sup>11</sup>

Then there came the popular explanation that the replacement ratio provided by unemployment insurance benefits was so close to 100 per cent in Europe that to lose one's job through no fault of one's own was to win life's jackpot: the disincentive to regain work made joblessness among experienced workers virtually permanent, thus raising the average unemployment rate in the affected (mostly European) countries. (The effect would be worse if the replacement of wages led employees to step up their shirking but I stick here to the popular theory.) Judicious scholars have shown that the UIB ratio is statistically significant in combination with a whole battery of variables, at least in time-series analyses.<sup>12</sup> It is interesting, however, that a simple cross-section scatter plot of the unemployment rate against the UIB ratio in 20 countries appears to owe its coefficient solely to Spain's data point. In any case, the explanatory power of the UIB ratio for unemployment differences is pretty negligible.<sup>13</sup>

The wave of new nonmonetary model building that several of us embarked on in the 1980s and tested with statistical analyses in the 1990s created a framework for analyzing unemployment (and other) effects of a great range of

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<sup>10</sup> See *Structural Slumps*, Ch. 17. See also Marco Bianchi, Bjorn Gudmundsson and Gylfi Zoega, "An Icelandic Natural Experiment in Supply-side Economics", *American Economic Review*, 91, December 2001, 1564-1579.

<sup>11</sup> Findings of mine and others support the premise that private (as well as social) wealth adds to unemployment. See for example Jean-Paul Fitoussi, David Jestaz, Phelps and Zoega, "Roots of the Recent Recoveries: Labor Reforms or Private Sector Forces?" *Brookings Papers on Economic Activity*, 1, 2000, 237-311, and Olivier Blanchard's discussion. See also Blanchard and Lawrence Katz, "Wage Dynamics: Reconciling Theory and Evidence," *American Economic Review Papers and Proceedings*, 89, May 1999, 69-74.

<sup>12</sup> Stephen Nickell, L. Nunziata, W. Ochel, G. Quitini, *The Beveridge Curve, Unemployment and Wages in the OECD from the 1960s to the 1990s*, CEP, LSE, London, 2002.

<sup>13</sup> Dean Baker, Andrew Glyn, David Howell and John Schmitt, "Labour Market Institutions and Unemployment," mimeo., New School University, New York, November 2002.

forces. The first in this line was actually Steven Salop's 1979 recasting of my 1968 turnover-training model of unemployment into a nonmonetary model.<sup>14</sup> I followed in a paper with Guillermo Calvo extending to general equilibrium the Phelps-Winter customer-market model.<sup>15</sup> Fitoussi-Phelps offered new ideas, though with money back in the models.<sup>16</sup> Finally, my *Structural Slumps* got the money out again and got *in* most of what I wanted, including actual/expected technical progress.<sup>17</sup> Some earlier results on expected technical progress were obtained by Christopher Pissarides and some later results by Hian Teck Hoon and myself.<sup>18</sup>

In that work of mine and kindred work by others, the explanatory variables were largely the models' *private market forces*, such as households' accumulated private wealth (or the income therefrom), firms' stocks of business assets and the overseas real interest rate, as well as some familiar *policy parameters*, such as direct taxation rates and social wealth, or entitlement, also figuring in the models. The statistical findings laid the broad rise of unemployment in the West to the great productivity slowdown in the mid-1970s, the huge rise of social wealth (and cumulated tax forgiveness embodied in public debt) between the 1960s and the end

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<sup>14</sup> Steven Salop, "A Model of the Natural Rate of Unemployment," *American Economic Review*, 69, March 1979, 117-125. A shirking model was introduced the same year in Guillermo Calvo, "Quasi-Walrasian Models of Unemployment," *American Economic Review*, 69, May 1979, 102-108. See also the analytical device of the wage curve in Carl Shapiro and Joseph Stiglitz, "Equilibrium Unemployment as a Worker Discipline Device," *American Economic Review*, 74, June 1984, 433-444. Labour unions were introduced in Richard Layard and Stephen Nickell, "Unemployment in Britain," *Economica*, 53, 1986, S121-169.

<sup>15</sup> Guillermo Calvo and Phelps, "A Model of Non-Walrasian General Equilibrium," in J. Tobin, ed., *Macroeconomics, Prices and Quantities*, Washington, D.C., Brookings Institution, 1983.

<sup>16</sup> Jean Paul Fitoussi and Phelps, *The Slump in Europe: Open-Economy Theory Reconstructed*, Oxford, Basil Blackwell, 1988.

<sup>17</sup> Phelps, *Structural Slumps: The Modern Equilibrium Theory of Employment, Interest and Assets*, Cambridge, Mass., Harvard University Press, 1994.

of the 1980s, and the overseas forces pushing up world real interest rates in the early 1980s.<sup>19</sup> The steep rises in labor taxation in the 1960s and 1970s were seen as a powerful, transient force.<sup>20</sup>

The findings also explained why some countries experienced a *greater rise* of unemployment than others did. First, because the great productivity slowdown circa 1974 was relatively severe on the Continent, where catch-up growth had been spectacular in the '50s and the '60s, it drove unemployment up far more there, especially in Italy and France, than it did in the U.S. and the U.K., where the slowdown was mild.<sup>21</sup> Second, findings that social-insurance wealth matters, as does private wealth, supported the thesis that, as the Continental nations regained in the postwar decades their long-run productivity paths, they responded with a huge increase in social insurance spending, mostly in the 1970s and even more strongly in the 1980s, the side-effect of which was a devaluation of work and a

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<sup>18</sup> See Christopher Pissarides, *Equilibrium Unemployment*, Oxford, Blackwell, 1990, and Hian Teck Hoon and Phelps, "Growth, wealth and the natural rate: Is Europe's jobs crisis a growth crisis?" *European Economic Review*, 41, April 1997, 549-557.

<sup>19</sup> These are the main results of a series of statistical studies starting from *Structural Slumps*, Ch. 17, through Phelps and Zoega, "Natural rate theory and OECD unemployment," *Economic Journal*, May 1998, 782-801, to David Jestaz, Jean-Paul Fitoussi, Phelps and Zoega, "Roots of the Recent Recoveries: Labor Reforms or Private Sector Forces?," *Brookings Papers on Economic Activity*, no. 1, 2000, especially the first part, 237-253.

<sup>20</sup> Recent analyses by Olivier Blanchard and Justin Wolfers and by Stephen Nickell et al. also find these forces at work and add others: Nickell the upward trend in the replacement ratio and the influence of unions, Blanchard the movement in factor shares Blanchard and Wolfers, "The Role of Shocks and Institutions in the Rise of European Unemployment: The Aggregate Evidence," *Economic Journal*, Conference Papers, 100, C1-C33; Nickell et al., "The Beveridge Curve, Unemployment and Wages in the OECD from the 1960s to the 1990s," in P. Aghion, R. Frydman, J. E. Stiglitz and M. Woodford, *Knowledge, Information and Expectations in Modern Macroeconomics: In Honor of Edmund S. Phelps*, Princeton, Princeton Univ. Press, 2002.

<sup>21</sup> There are two channels: The ensuing expectation of slower trend growth of productivity operated like a rise in expected real interest rates, as first shown in Christopher Pissarides' 1990 book (and touched on here and there in *Structural Slumps*). Second, with productivity and hence wages growing more slowly, workers' asset holdings began to rise toward a higher level as a ratio to the wage; theoretically, the income or services from all these riches weakened workers'

consequent rise in Continental unemployment rates; in contrast, far more of the welfare state in the U.S. and the U.K. had already been built in earlier decades. Third, the significance of the world real interest rate variable gave support to the thesis that when the surge of military spending and tax cutting in the U.S. and later the investment boom in east Asia and China ended the era of a low world real interest rate, Continental saving was pulled out to finance decreased saving in the U.S. and increased investment in east Asia, which squeezed Continental investing in new plants, new customers and new employees, lowering employment and real wages.<sup>22</sup>

The crucial point for this paper, however, is that the forces that sufficed to explain why Continental unemployment rates in the 1980s and 1990s are *higher than before* and *rose more* than they did elsewhere do not suffice to explain why those rates are now *higher than in the comparators*, the U.S. and the U.K.<sup>23</sup> The fact that macroeconomic *changes* produced an unemployment rate *change* of 5.5 percentage points on the Continent against a mere 2 percentage-point change in the U.S. and U.K. (averaged) does not rule out a large role for *institutions* in explaining *inter-country differences* in unemployment rates and other performance indicators. It is still logically possible that the Continent labored from the beginning with

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incentives not to quit or shirk at the drop of a hat. The benefits offered by social entitlements likewise rose as a ratio to the slowed-down wage, with the same effects.

<sup>22</sup> Later, we found that demographics helped greatly in lowering the U.S. unemployment rate through a steep upward trend in the proportion of US workers with some college and in the proportion with a college degree – groups relatively immune to joblessness. In the high-school dropout group, unemployment in the 1980s was nearly double the rate in the 1970s and it did not get out of “double digits” until the mid-1990s, as if it were a country on the Continent.

<sup>23</sup> Had those rates been at zero in the 1960s and had their increase caught up with the *initial* level in the U.S. and U.K. *plus* the subsequent increase there, one would have to work harder to explain why the *rise* does not explain the new *differential*.

*institutional disadvantages* the absence of which would permit Continental rates of 1 or 2 or even 3 percentage points *lower* than they actually are now; and would have permitted rates 1 or 2 points *lower* than they were in the 1960s (without hitting zero). We are apt to overlook this possibility because unemployment rates on the Continent were so extraordinarily low to begin with that we cannot easily imagine their being even lower with different institutions. But even if Continental jobless rates had all been zero in the 1960s, that would not mean that institutions then could not have been better; it would only mean that better institutions had no room in that *temporary situation* to decrease unemployment further.

In proposing to address institutions I don't mean to re-invent what Layard, Nickell and Jackman started doing with their 1991 book.<sup>24</sup> That approach sees certain institutions as amplifying bad shocks. A difficulty with it is that such an amplification would also apply to good shocks; and there was no shortage of good shocks in the 1990s. But I am not concerned with that difficulty. My thinking about institutions is not about amplification and it has a different focus.

### **The Crucial Role of the Economic System's Institutions**

Over the years I have come to hypothesize that many of the sharp differences among the advanced economies in their *institutions*, differences created by their histories or their understanding of how the economy works or maybe their values, are important causes of disparities in these countries' *dynamism*; further, that those disparities are responsible for a large part of the variations in these countries' *economic performance*. Three years of research on the Italian economy raised my

suspensions on this score and forced me to put my thoughts into what I hope is a coherent (though not fully built) framework.<sup>25</sup>

What do these terms mean and where is unemployment in this thesis?

Economic performance has several dimensions, of course. For me at any rate, the performance of an economy is better if, following one or more sorts of structural, particularly institutional, changes, there results increased *productivity* (thus wages), jobs with greater *stimulation and challenge* (leading to greater job satisfaction and greater intellectual development), broader *inclusion* (thus wider access to jobs) and, finally, more *robustness* against downside shocks (thus less severe downturns).

All these improvements, I would argue, act to lower unemployment. A lift to (the path of) productivity, in normal cases, will tend to raise wage rates and, in so doing, to shrink unemployment (as long as wealth does not catch up). Greater job satisfaction will obviously boost employees' loyalty – reduce their quitting, shirking, absenteeism and other pathologies – and that presumably has a permanent effect on unemployment. Changes, such as policy measures, that widen inclusion tend to reduce unemployment rates among those whose inclusion has been only marginal, sporadic, or precarious. And reduced risk of deep downturns, besides shaving off some of the peaks in the unemployment series, encourage firms to invest more in their employees and workers to invest more in their own skills, both possibly reducing unemployment rates in good times.

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<sup>24</sup> Richard Layard, Stephen Nickell and Richard Jackman, *Unemployment: Macroeconomic Performance the Labour Market*, Oxford: Oxford University Press, 1991. See also Blanchard and Wolfers, "The Role of Shocks and Institutions in the Rise of European Unemployment," *op. cit.*

<sup>25</sup> Phelps, *Enterprise and Inclusion in Italy*, Dordrecht, Kluwer Academic Publishers, 2002.

Dynamism refers to vitality plus direction. “Greater dynamism” means a greater volume of *well-directed innovation* – either more innovations (per unit time) to select among or better selection or both. The current growth rate is not the measure of this dynamism. At best, the economy’s productivity growth under *current circumstances* is a sign of how much dynamism there is. For example, while America’s economy is becalmed, that is not a reliable sign that America has somehow lost its dynamism. While western continental Europe grew phenomenally fast in the ‘60s and ‘70s, that does not signal the Continent has an extraordinarily dynamic system (and has been thwarted by current market conditions).

On what grounds do I argue that such dynamism promotes economic performance? First, high performance consists of not just high survival rates and low destitution rates but also, very importantly, people’s intellectual development in the work, or projects, offered to them over their active ages – one of the satisfactions from work on which unemployment and participation rates depend in turn. (Even a dog wants to learn tricks and advanced zoos are beginning to engage apes in problem-solving.) Such intellectual development results if people’s jobs enlist their minds and lead them to discover some of their talents and expand their capabilities: Henri Bergson’s *becoming* versus *being*. We are doing well if and only if we are getting better. Second, such mental stimulation requires the challenge of *change*: new problems to be solved, new tasks to be mastered, new abilities to be acquired. And that is provided by an economy whose institutions generate

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economic dynamism, or what Schumpeter called economic development.<sup>26</sup>

It is widely thought that certain institutions of capitalism, if operable in the country in question, are best fitted to produce such dynamism. Schumpeter's early model is usually cited in which entrepreneurs enter with start-up firms to try out their ideas and drive out older firms, Darwinian style.<sup>27</sup> In the Interwar years, though, it was claimed that socialism could do as well or better: state enterprises could have entrepreneurs and state banks could finance the best ideas. Corporatist systems of state and social-partner control without state ownership were instituted in Italy and elsewhere to harness the economy to the national interest.

The ensuing debate over systems stirred contributions by several European intellectuals toward a model in which dynamism is created by the interaction of certain institutions of capitalism. Mises, sparking the property-rights school, said that the "motive force" of capitalism's entrepreneurs was their unfettered maximization of their own profits. This force socialism sought to do without and corporatism hampered with barriers to entry and political bargaining.<sup>28</sup> Hayek said that capitalism's entrepreneurs were not appointed or licensed: they were self-selected, inspired by their particular experience and emerging visions; thus capitalism opened itself to the experience and knowledge of many participants,

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<sup>26</sup> Joseph A. Schumpeter, *Theory of Economic Development* (1911), Harvard University Press, Cambridge, Mass., 1932. He speaks of new and discontinuous changes in uses of labour (p. 95).

<sup>27</sup> Schumpeter, *Theory of Economic Development* (1911), Harvard University Press, Cambridge, Mass., 1932, p. 66.

<sup>28</sup> Ludwig von Mises, *Die Gemeinwirtschaft* (1922), 2<sup>nd</sup> edn., Jena, 1932, trans. J. Kahane, *Socialism*, London, Jonathan Cape, 1936. He denied making the criticism that pricing is too complex a matter for socialism to administer, crediting it instead to the eclectic Hayek.

potentially all of them.<sup>29</sup> Mises also noted that the entrepreneurial project is not objectively valued until launched and tested in the market. The creative leaps of entrepreneurs involve what M. Polanyi called “personal knowledge,” or tacit knowledge, which isn’t in books and thus goes beyond what can be communicated or acquired in familiar terms.<sup>30</sup> For that reason, as Frydman et al. say, heads of socialism’s state banks or corporatism’s big banks, being accountable to the state or much of the nation’s depositors, would not be comfortable accepting a relatively novel project for financing.<sup>31</sup> (If they took on such decisions, they could engage in self-dealing, claiming truthfully or not that the rejected applications were even more uncertain than the accepted one.) For the same reason, even in capitalism a particular financier could not be counted on (contrary to Schumpeter’s naïve view) to rank the economy’s whole set of investment projects, since no one would have a general background. So it is crucial that an entrepreneur have access to a pluralism of financiers from which to seek financing, not just one source.<sup>32</sup> Similarly, by analogy, entrepreneurs must have access to a pluralism of managers from whom to pick the one most in tune and with the right background. In short, capitalism’s entrepreneurs have the advantages of a high *incentive* to innovate but also of wide

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<sup>29</sup> A standard citation is Hayek’s “The Use of Knowledge in Society,” *American Economic Review*, 35, 519-530, 1945. More central is his “Competition as a Discovery Procedure,” *Collected Works*, U. Chicago Press, 1999.

<sup>30</sup> Michael Polanyi, *Personal Knowledge*, Chicago, University of Chicago Press, 1962. A forerunner was the “animal spirits” of the entrepreneurs in Keynes’s *General Theory*.

<sup>31</sup> Roman Frydman et al., “Why Ownership Matters,” in Fox, M. and M. Heller (eds.), *Corporate Governance Lessons from Transition Economy Reforms*, Princeton Univ. Press, 2001. Accountability was a major theme in the conference volume, *Mass Privatization in Eastern Europe*, *Rivista di Politica Economica*, 81, December 1991.

*access* to the product markets they wish to enter, to a pool of diverse financiers willing to bear the uncertainty of entrepreneurial projects and to a diverse pool of educated managers capable of coping with the new product or new market.

I find this perspective extremely suggestive. Yet a crude typology of monolithic Capitalism, Corporatism and Socialism would not be applicable. No real-life country uses only institutions of one system and none of the other two. Some capitalist institutions may be an evolutionary mistake, ineffective for generating dynamism or a hindrance. So we need to study individual institutions. But it is not only the economic institutions that matter. I suggest three *kinds* of institutions in a country as potentially important determinants of dynamism: 1<sup>st</sup>, the *operating system* of the country's economy, with its mix of economic institutions – the focus of the early Interwar theorists. 2<sup>nd</sup>, the country's broad *social* policies and attendant institutions, such as entitlements legislation. 3<sup>rd</sup>, the country's *cultural attitudes*.

*The operating system.* The market economies of the OECD do not all have the same sort of operating system. The predominance of *private ownership* is universal but the degree of private *control* is limited in varying ways. At the *capitalist* end we don't find Smithian capitalism – an ideal construct of atomistic self-financing firms, atomistic workers and a government that has only to establish and enforce property rights and to administer justice to violators. Modern systems of finance-

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<sup>32</sup> A state investment bank or the sort of big bank characteristic of corporatism would tend to reject the greatly innovative proposals since it couldn't handle the greater ambiguity of the evidence on behalf of these.

capitalism have corporations too big to be controlled by a single person through a large block of shares and so have to be public companies. Such systems, recognizing information-based moral hazards to shareowners preventing their full corporate control, include extensive regulations against fraud and theft (called “tunneling”). Recognizing the hazards to investors from managers’ self-dealing, misjudgements or negligence, these systems also include regulatory standards of disclosure, transparency, accounting and board membership. These unSmithian systems still leave *uncoordinated* entrepreneurs with relatively unobstructed opportunities to compete for external financing of proposed innovative projects by *uncoordinated* stock-market investors and venture-capital funds counting on selling the shares they acquire through an initial public offering to the stock market.<sup>33</sup>

The present-day operating system of continental western Europe, for all of its capitalist elements and vestiges, is more corporatist. The *classic* corporatist model was pioneered on the Continent in the ’20s in the name of mediating conflicts between interest groups, particularly labor and capital. It took the form of a tripartite system of big corporations, big industrial unions and big banks, all presided over by a big bureaucracy that could negotiate with their the leaders (of the corporations and so forth), control economic change through barriers to entry, licenses and standards, exert influence over big banks and, in some countries, wield power of some companies through government shareholdings. A familiar instrument of corporatist control effectively taxes the monopoly profits of the

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<sup>33</sup> Some features of regulatory law serve to protect entrepreneurs; bankruptcy laws, for example.

domestic banks or provides state loan guarantees to finance reduced-cost loans for favored investment projects or favored enterprises.

The core of corporatist systems is that they are run by elites who hold authority in the government, the large corporations and the large unions. These elites impede or block new firms, new unions, and new banks from entering to compete with incumbents. Big changes require consensus among these elites.

In other dimensions the thrust of corporatism is flexible. Prewar corporatism actually weakened labor unions in some European countries, even outlawing strikes and reducing (probably inflated) wages. Then postwar corporatism empowered unions through Italian *concertazione*, German co-determination (*mit Sprache*), workers councils, and an unqualified right to strike. On the other hand, the Netherlands, with the Wasenaar pact, apparently used the corporatist scaffolding to negotiate increased employment. “Coordination” of a country’s workers and of its firms in wage setting is still widely used as a *sign* of the “degree” of its corporatism.

A *decentralized* instrument of control in a somewhat corporatist spirit surrounds each corporation with a set of “stakeholders,” such as community representatives and local labor leaders. They may be able to block the opening of a new plant or the closing of an old one.

This corporatism was seen by its theoreticians as a market economy that is both more efficient and more humane than the disorganized, and therefore wasteful, inequitable and unstable system that capitalism was held to be. The presence of

these benefits need to be tested. They could be large. But the costs could be larger.<sup>34</sup>

One cost of corporatism, which has received much emphasis, is that it lends itself to cronyism and corruption, in which contracts are won and resources allocated on the basis of connections and bribes rather than price competition. This is both inefficient and inequitable. Another of its costs is its tendency to stimulate wasteful rent-seeking from the bureaucracies.

What may be the worst cost by far, however, is that corporatism may cost the economy a great deal of its potential dynamism. In operating almost intentionally to slow or to resist change except when there is a consensus for it, corporatism is very poor at providing the adventure, the mental stimulus and the succession of challenges at work on which business people will depend for their intellectual development and personal growth. And if jobs are less compelling and engaging as a result, there may result collateral damage in reduced labor-force participation and diminished employee morale, leading to increased unemployment. In a very literal sense, corporatism prevents the economy from being as *developed* as it would be under an operating system hospitable to innovation. The corporatist economy is stultifying.

The prime modus operandi here is the many permissions and licenses that are required in order to be allowed to start up a new firm. If every new firm has to

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<sup>34</sup> A proponent of postwar corporatism was Ezio Tarantelli in *Economia Politica del Lavoro*, Torino, UTET, 1986. An early critic was Herbert Giersch in *Openness for Prosperity*, MIT Press, 1993, 151-4.

run this gauntlet, quite a few applicants will not make it through the process. And if every new firm has to have such wide approval, many entrepreneurs will not even try to start up a new company. (Yet perhaps some of the Continent's social policies are also at fault here.)

*Social policy.* Social policy in western continental Europe has institutional features not found in the U.S. and even the U.K. Everyone knows that Europe's social insurance and social assistance system tends to be more massive and more comprehensive than the one in the U.S. Europe's personal income tax is generally more progressive than the American one too.<sup>35</sup>

Regarding social insurance, it is pretty clear that the provision of so many benefits is a kind of wealth (I call it social wealth) that may very well weaken employees' attachment to their jobs and thus raise the unemployment rate. However, it is not at all clear that this social wealth discourages entrepreneurship and thus dynamism. At the dawning of the welfare state, in fact, social theorists such as William Beveridge saw social insurance and assistance programs as fostering resilience, versatility and self-confidence. (On the other hand, self-employed entrepreneurs in most European countries gain little here, being ineligible for several of the social insurance benefits that employees can obtain.)

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<sup>35</sup> The U.S. also has a social welfare system – in a medical emergency those without insurance or documents are issued at once a temporary Medicaid card – but not as comprehensive and, in general, not as generous, though there are exceptions. The main lacuna in the American system is that low-wage employees are ineligible for Medicaid yet typically lack other medical insurance since their employers, whom the system offers a tax incentive to provide their employees with medical insurance, find it too expensive to extend that insurance to their low-productivity employees. The states insist on a uniform insurance program for all employees and pile up insurance protections that the politicians believe their middle-income voters want.

Progressive income taxation, that is, high tax rates on upper incomes, were originally seen (and perhaps still are) as a way to boost after-tax wages and employee morale at the low end and mid-range of the labor force; such effects might possibly reduce the unemployment rate. However, it is plausible that such income-leveling may cost the economy some loss of dynamism (in which case the progressivity may be harmful on balance to productivity, to job satisfaction, and to other aspects of economic performance). Conservative economists in America argue that entrepreneurs must invest money of their own in order to obtain the rest of the money from the venture capitalists and if the tax rates on their incomes are high (because they have high incomes), they will be unable to start up new companies.

For dynamism, the most problematic part of Continental social policy is something quite different. In the name of “social protection,” meaning protection from “the market,” Continental social policy is quite interventionist toward the market in several ways. Employment protection legislation aims to protect employees from dismissal by exacting large penalties on employers for dismissing their workers. The *exception culturelle*, which is not confined to France, protects vested interests in the entertainment sector from overseas competition through quotas on TV programming and subsidies to established domestic producers.

On close examination, this social protection is selective in such a way as to hinder new entrepreneurs and thus to reduce dynamism. As a collaborator of mine, David Jestaz, points out, the French subsidies to the arts seldom if ever go to *new* producers to help them to enter the market with new domestic product –

new filmmakers, new musicians, and so forth. Since the same entrenched producers and artists get each year's subsidies, potential new producers find it all the more difficult to break into the field. As another young economist, Rainer Fehn, points out, there is an inverse relation among European economies between protection of investors and entrepreneurs on the one hand and protection of employees.<sup>36</sup>

Marco Buti and colleagues have observed that generous employment protection is a low-cost substitute from the standpoint of government finances for generous unemployment insurance benefits: in general, some countries use one, others use the other.<sup>37</sup> But from society's standpoint it is not at all clear that these are close substitutes, with one as bad or as good as the other, since entrepreneurs contemplating a start-up firm may be scared off by the probabilistic costs of having to downsize in the event that the new venture has disappointing sales.

*Cultural attitudes.* Another distinguishing feature of the setting in which continental European economies operate is their culture, which appears to contrast mightily with America's ethos of ambition, competition, self-help and initiative. We commently give little attention to economic culture for the good reason that we cannot be sure it is a cause, not just an effect. But we can still recognize it.

In Europe, there is still an antipathy toward money-grubbing, though not as strong, it appears, as it once was. As Hans-Werner Sinn remarked to me, a German would rather say he had inherited his wealth than have to say he made it himself. A

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<sup>36</sup> Rainer Fehn and Carsten-Patrick Meier, "The Positive Economics of Labor Market Rigidities and Investor Protection," CESifo Working Paper 456, April 2001.

theme in recent papers by Mark J. Roe is that, in Europe, there is relatively poor acceptance of outside profits from successful investment projects, with the result that political structures arise to determine and stabilize the division among the social partners.<sup>38</sup> Investors receive little protection and gain little corporate control because there is little competition in product markets, so giving increased weight shareowner value would lead to increased mark-ups and output contraction. The bottom line is that entrepreneurs weighing entry would expect to have to hand over an appreciable share of the profit in the event that their venture succeeded while they could expect nothing in the event it failed.

European children do not grow up with the same experiences as American children. In contrast to most children in Germany, France and Italy, American children generally begin baby-sitting for money at an early age, progress to summer jobs as waitresses and cashiers, and some reach more sophisticated jobs as camp counsellors, musicians and interns before they are out of their teens. This way they learn what is involved in work – the value of money (how hard it may be to earn it) and work's demands (the importance of discipline and teamwork) – and the gratification from earning one's own way. Europeans' sheltering their children from such early experience could inadvertently channel them away from business.

Another cultural difference is that American children leave home at 18, some earlier; the same is true in the U.K. They are largely self-supporting after that

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<sup>37</sup> Marco Buti, Lucio R. Pench and Paolo Sestito, "European Unemployment: Contending Theories and Institutional Complexities," European Investment Bank, Report 98/01, 1998, 40pp.

<sup>38</sup> Mark J. Roe, "Corporate Law's Limits," *Journal of Legal Studies*, 31, June 2002, 233-271.

age, except for emergencies and college tuition. Continental offspring expect family support for as long as desired. A recent court case in Italy cites full and indefinite support as a legal right. An explanation of economists is that the European housing market does not permit the youth to move out. In any case, most Europeans see this continuing family support as healthy. It does appear true that European youth have a lower incidence of alcoholism and drug addiction than American youth. Critics of this dependency think it breeds an unduly large share of young people who have little sense of independence and who are unwilling to strike out on their own.

If some or all of these things are true, the continental European countries, especially the Big 3, which have done so badly in the past decade, would do well to attempt some changes – not a wholesale revolution but selected changes, in some cases incremental changes – in the hope of sharply boosting the dynamism of their economies. If I am right, higher employment would be one of a whole range of benefits that would result.

### **A Glance at Some Evidence**

I will discuss in the small remaining space some evidence in favor of elements of my thesis on the sources of dynamism and its benefits for performance.

Part of the evidence is simply an imaginative reading of recent history, which is perfectly legitimate though not sufficient to convince. The Continent enjoyed rapid growth when it could exploit the yawning gap that had opened up between its technological practice and the best practice in the world – generally

U.S. practice but later also Japan's practice in some of its export industries. This gave a misleading impression that its economy was structured for dynamism somehow. In fact, the dearth of dynamism became apparent once the gap had narrowed to such an extent that investing of all kinds – in new employees, new plants, etc. – was no longer at the elevated levels necessitated in the catch-up phase. Then unemployment rates crept up inexorably to much *higher* levels than the range in which the rates fluctuated in the U.S. and the U.K. It is pretty compelling that what the Continent needs to spark higher levels of activity is a return to higher rates of such investing, though of course it will not be possible to get back to the rates of the 1960s. Yet it is fair to say that this recent experience is inspiration for my thesis, not a test of it.

What, then, are the thesis's testable implications? Here is one set of tests: Corporatist systems tend to inflate the share of gross income going to capital rather than labor by suppressing competition among incumbent firms and by controlling and impeding entry of new start-ups innovators. This same monopolization plus the costs of the bureaucratic red tape and the unanimity-seeking required by investment projects tend also to depress the value (per unit) put by CEOs on all or most of the various business assets (plant, equipment, job-ready employees, customers) in which firms must invest in order to make profits. The result, in turn, of this weakness in business-asset values is diminished investment in these assets by the business sector and thus weakness in real wages, employment and entrepreneurship. Are these predictions borne out by the data? It seems to me that

they are. Capital's share is far bigger on the Continent, I believe, than in the U.S. and U.K. and share prices are, I believe, far more depressed. And this has been the pattern for a decade.

Some novel ideas for empirical tests began arising in the course of a paper I did with Gylfi Zoega a couple of years ago on investment booms, which followed a preliminary piece in the *Financial Times*.<sup>39</sup> The background to this research was the record-breaking investment boom in the U.S. over the second half of the 1990s, which was not explained by existing models (at least not models that tie the expected growth rate of productivity to recent growth). My modeling of the boom was based on the theory, given an intuitive expression by Spiethoff and Cassel, that asset values and thus investment activity jump *off* their accustomed saddlepaths and *onto* (explosive) boom trajectories when there is the sudden expectation of new uses for capital (at normal rates of return) – in some new method, new product or new region – *at some future date*. These effects are apt to be “signalled” by the value of the *stock market* per basket of business assets or per unit of GDP. (In the unemployment equation studied in the 2001 piece this “normalized market cap” variable performed very well.) Thus market economies are excited by visions of future lifts to productivity. At least the more entrepreneurial ones are.

It also came to me that investment booms may be generally good (on balance) and are a sign of dynamism. A productively creative economy has the

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<sup>39</sup> Phelps and Zoega, 'Structural booms: Productivity expectations and asset valuations,' *Economic Policy*, no. 32, April 2001, 85-126. See also Phelps, 'Europe's stony ground for the seeds of growth,' *Financial Times*, August 9, 2000.

occasional investment boom followed by a spell of tidying up, learning by doing and the occasional research just as a productively creative person has the occasional rush of energy and focus, then returns to a relaxed and ruminative state.<sup>40</sup>

These thoughts led to a question: If some economies are more capable of responding to the prospects driving a boom than others, was there evidence that the countries having the strongest booms in the late 1990s had more entrepreneurial economies? More of certain capitalist institutions and fewer of certain corporatist ones? Yes. Some countries were clear boomers – the U.S., U.K. and Holland, with Canada, Australia and Sweden less so, others non-boomers – Germany, Italy and Belgium, with Spain, Austria and France showing more life. And the endowment of institutions among the former differed markedly from that of the latter.

The data tend to confirm that a country was more likely to have seized the boom if it had capital markets providing entrepreneurs with access to venture capital and stock exchanges offering liquidity and transparency, product markets open to start-ups and to new entrants generally, and labor markets offering opportunities to hire and boss and fire employees without large and uncertain penalties and restrictions. The ranking of countries by strength of the boom correlates well with several institutional indicators: notably, the OECD index of bureaucratic red tape and the OECD employment protection index. It is also weakly correlated with that strange “index of corporatism” sometimes used, the

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<sup>40</sup> Phelps and Zoega, “Structural Booms,” section 5. See also Phelps, ‘IMF seems to have lost

degree of employer- and union-coordination in wage setting. (These good results are not regularly obtained.)

Two much more original results are, for me, most arresting. The proportion of the labor force having a university/college degree turned out to be strongly correlated with a country's ranking by strength of the boom. The inspiration to try this indicator came from the Nelson-Phelps paper.<sup>41</sup> That simple model of the diffusion of innovations emphasizes the facilitating role of advanced education in an entrepreneurial economy: managers have to use their education to solve the many problems that new ideas pose. A corollary I would add here is that *without* such problem-solving capacity in others, innovations will be few and far between. Entrepreneurs will innovate fewer intermediate products and new consumer goods if their diffusion would be slowed or permanently limited by the dearth of sophistication among the managers, employees or households on whom adoption and use would depend. Furthermore, entrepreneurs, who may themselves not be of sterling educational attainment, can't design and launch commercial innovations without well-educated managers to address legal, technical, financial and even cultural problems that come up.

Another unexpected result was the stunning predictive power of the proxy for the prior development of the stock market – stock market capitalization in 1988 normalized by the GDP. There are three reasons for its importance, I believe. First,

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sight of rationale for capitalism,' *Financial Times*, April 25, 2000.

<sup>41</sup> Richard Nelson and Phelps, "Investment in Humans, Technological Diffusion and Economic Growth, *American Economic Review*, 61, May 1966, 69-75.

innovators often want a stock market for their financing or require a venture capitalist who will in future need to sell their shares to that market. Second, the listing of a firm's shares in a stock exchange is like a seal of approval, which boosts the price of the shares, since to gain listing the firm has to meet requirements for financial accounting – transparency, frequency, prompt disclosure – that the exchange finds advantageous to impose. Finally, the stock market establishes benchmarks indicating what various kinds of enterprises are worth, which helps investors in the private equity market.

The last exercise has been to examine how the *levels* of the various performance indicators, such as the unemployment rate and labor productivity, correlate across the (large) OECD economies with these institutional data. This work is in its infancy. An initial look at the data is provided in some recent reflections.<sup>42</sup> I look at these levels in a relatively normal year, namely 1995, just before the upheaval of the investment boom in several of our twelve economies – as if the economies were in a steady state that year. No purpose would be served by repeating here the exposition of those results. Suffice it to say that they are favorable to my thesis that institutions fostering dynamism correlate positively with performance level and institutions blocking or inhibiting dynamism correlate negatively with performance.

Let me conclude: It seems to me quite reasonable to surmise from this

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<sup>42</sup> Phelps, "Reflections II," in Philippe Aghion, Roman Frydman, Joseph Stiglitz and Michael Woodford, *Knowledge, Information and Expectations in Modern Macroeconomics: in Honor of Edmund Phelps*, Princeton, Princeton University Press, 2003.

evidence, in conjunction with the few precious theoretical insights we have so far about dynamism, that *economic* institutions – not just the political/legal institutions and the social institutions that have received so much attention in recent years – are deeply involved in determining a country's economic performance in general and its employment (both participation rates and unemployment rates) in particular.

Table 1: The 1990s Investment Boom: Measures and Some Sources

	Mean Annual Growth Rate of:			Stock-Market	Red	Union &	Univ'ty
	Fixed	Real Exchange	Labor's	Capitalization	Tape	Employer	Degree
LF	Investment	Rate	Share	in % of GDP	Index	Coord'n	in % of
<b>A strong general investment boom in evidence</b>							
U.K.	10.8%	8.5%	2.0%	80	0.5	2	21
U.S.	10.6%	4.3%	0.6%	50	1.3	2	33
Canada	11.6%	-2.2%	1.3%	45	-	2	37
Holland (1997)	7.6%	0.9%	0.3%	40	1.4	4	22
Sweden (1997)	9.1%	-2.4%	2.1%	50	1.8	6	28
Australia(1995)	8.5%	-0.2%	-0.4%	50	-	-	24
<b>Few signs of investment boom driving the expansion (if any)</b>							
Austria	8.7%	-1.4%	0.1%	13	-	6	8
Spain	8.8%	-1.3%	-0.7%	25	1.8	3	16
France	6.2%	-1.9%	-0.3%	25	2.7	4	19
Belgium	6.0%	-1.9%	-1.1%	42	2.6	4	25
Italy	4.0%	0.3%	-0.7%	18	2.7	4	8
Germany	3.6%	-2.2%	-0.1%	22	2.1	5	23
euro zone	5.7%	-1.5%	-0.5%	-	-	-	-

Source: OECD, *Economic Outlook* June 2000, Appendix and Chapter VII.

NOTES: Mean growth rate is the mean of the annual growth rates up to 1999 from 1996 or the start date given in parentheses. Investment is real gross private non-residential fixed capital formation. Compensation per employee is real total labor cost per person employed in the business sector. Labor's share is compensation per employee to output per employee in the business sector; only the growth rates from 1996 are available. The exchange rate is an index of trade-weighted nominal rates deflated by consumer price indices. Market capitalization figures from Morgan Stanley Capital International are for 1988. The OECD red tape index is from *The Economist*, July 1999. Proportion of labor force with university degree is from the OECD.