

The Dynamism of Nations

by [Edmund S. Phelps](#)



[Edmund S. Phelps](#)

Proposals for economic reform of Continental Europe keep coming. The process does not constitute a unified, reasoned debate so much as an ongoing political auction in which special interests seek votes for the policy change that will benefit them.

Some say the bar to a good economy is the Continent's inflated welfare state and the solution is retrenchment, beginning with raising retirement ages. Others say the impediment is the entire overgrown public sector and the solution is to cut tax rates. The latest view, endorsed by the European Commission, blames a shortage of infrastructure and proposes more bridges and tunnels.

This approach will never reach the heart of the matter. The West's core social values make high economic performance a moral imperative like free speech or trial by jury. Further, the Continent will undoubtedly need some transformative changes of its economic institutions to establish high-performance economies. To reach broad agreement on those changes requires facing some basic questions so far ignored.

A real debate on basic reform has to start with an explicit conception of economic performance - of what constitutes a good business life. Productivity is an important element. Only a high-productivity economy can promise all or most working-age persons a range of careers at high wage rates.

But high productivity is not the only element of high performance. The other element is thriving, prospering participants. This requires jobs to be rewarding in more than pecuniary ways - enlisting the minds of employees, engaging them in problem solving, leading them to discover some of their talents and expanding their abilities. This personal growth, while an end in itself, is also a source of job satisfaction, which in turn boosts participation in the labor force, and of high employee loyalty, which lowers unemployment, making more good jobs available.

What is needed for high performance? Basically, it is productive change, which I call *economic dynamism*. For employees to develop, they must be imbedded in a stimulating

workplace, with new problems to solve, harder tasks to be mastered, added abilities to strive for. Less obviously, a country does not want misguided or pointless change; it wants investments that appear to the financial sector as productive.

The late 1990's produced evidence that low dynamism was associated with weak economic performance, particularly low prosperity. Of the 12 large OECD economies, three--Germany, Italy, and France--were conspicuously un-dynamic: they missed the 1990's investment boom or were awfully late to it. These same economies also ranked at or near the bottom in unemployment and labor-force participation, both before the boom and now.

What are the requirements for dynamism? Yale University's Robert Shiller has suggested that I believe that Europeans lack dynamism owing to a deficiency of entrepreneurial "spirit." I have pondered the expressed uneasiness of Europeans about making money, and speculated that their schooling might drain away some playfulness and creativity. But that is not my explanation of Europe's problem. For one thing, it is hard to decide whether such cultural patterns are causes or effects of dynamic economies.

My thesis 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.

Evidence exists for this thesis. One could have predicted in advance of the recent boom how the 12 large OECD economies would rank simply by knowing the percentage of the population with a university degree, the OECD index of barriers to entrepreneurs, and the breadth of the stock exchange (measured by the market value of outstanding shares relative to GDP years before the boom).

This evidence linking employment to dynamism and tracing dynamism to favorable institutions, such as a well-developed stock market, and to obstructive institutions, such as myriad licenses for entry by new firms, is an advance in our understanding of healthy economies. It is useful to know that there is vastly more to creating economic dynamism than private property; and that high unemployment is not to be laid solely to labor market restrictions.

Is there evidence *directly* associating high performance - that is, 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.

A cross-country analysis estimates that university education is good for all three elements of economic performance: the employment rate (relative to the working-age population),

the unemployment rate (relative to labor force), and labor productivity too. Scoring high on the OECD index of barriers to entrepreneurs is bad for all three elements of performance. A high level of job protection is bad for productivity but does not have a clear effect on either employment rate or unemployment rate.

I have suggested that the organizational structure of the Continental economies limits their performance. This corporatist structure - labor unions, workers councils, employer confederations, and big banks - facilitates direct interventions in economic decision making to give interest groups protection and veto power.

In fact, among the 12 large OECD nations, a higher degree of corporatism as commonly measured is loosely associated with lower employment and lower productivity. The reason for these negative effects appears to be that high corporatism is strongly correlated with stifled entrepreneurship and obstructive job protection. The corporatist structure by itself does not detract from performance.

Here again, the truth lies in the nuances. This is precisely why Europe should be debating about the Continent's real problems, not locking their economies into corporatism by enshrining the "social market economy" into the emerging EU constitution.