

Entrepreneurial Culture Why European economies lag behind the U.S.

By Edmund S. Phelps

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The nations of Continental Western Europe, in the reforms they make to try to raise their economic performance, may prove to be a testing ground for the view that culture matters for a society's economic results.

As is increasingly admitted, the economic performance in nearly every Continental country is generally poor compared to the U.S. and a few other countries that share the U.S.'s characteristics. Productivity in the Continental Big Three--Germany, France and Italy--stopped gaining ground on the U.S. in the early 1990s, then lost ground as a result of recent slowdowns and the U.S. speed-up. Unemployment rates are generally far higher than those in the U.S., U.K., Canada and Ireland. And labor force participation rates have been lower for decades. Relatedly, the employee engagement and job satisfaction reported in surveys are mostly lower, too. It is reasonable to infer that the economic systems on the Continent are not well structured for high performance. In my view, the Continental economies began to be underperformers in the interwar period, and have remained so--with corrective steps here and further missteps there--from the postwar decades onward. There was no sense of a structural deficiency during the "glorious years" from the mid-'50s through the '70s when the low-hanging fruit of unexploited technologies overseas and Europeans' drive to regain the wealth they had lost in the war powered rapid growth and high employment. Today, there is the sense that a problem exists.

What could be the origins of such underperformance? It may be that the relatively poor job satisfaction and employee engagement on the Continent are a proximate cause--though not the underlying cause --of the poorer participation and unemployment rates. And high unemployment could lead to a mismatch of worker to job, causing job dissatisfaction and employee disengagement. The task is to find the underlying cause, or causes, of the entire syndrome of poorer employment, productivity, employee engagement and job satisfaction.

Many economists attribute the Continent's higher unemployment and lower participation, if not also its lower productivity, to the Continent's social model--in particular, the plethora of social insurance entitlements and the taxes to pay for them. The standard argument is fallacious, though. The consequent reduction of after-tax wage rates is unlikely to be an enduring disincentive to work, for reduced earnings will bring reduced saving; and once private wealth has fallen to its former ratio to after-tax wages, people will be as motivated to work as before.

An indictment of entitlements has to focus on the huge "social wealth" that the welfare state creates at the stroke of the pen. Yet statistical tests of the effects of welfare spending on employment yield erratic results. In any case, it is hard to see that scaling down entitlements would be transformative for economic performance. (Indeed, some economists see increased wealth, social plus private, as raising the population's willingness to weather market shocks and helping entrepreneurs to finance innovation. I am skeptical.)

In my thesis, the Continental economies' root problem is a dearth of economic dynamism--loosely, the rate of commercially successful innovation. A country's dynamism, being slow to change, is not measured by the growth rate over any short- or medium-length span. The level of dynamism is a matter of how fertile the country is in coming up with innovative ideas having prospects of profitability, how adept it is at identifying and nourishing the ideas with the best prospects, and how prepared it is in evaluating and trying out the new products and methods that are launched onto the market.

There is evidence of such a dearth. Germany, Italy and France appear to possess less dynamism than do the U.S. and the others. Far fewer firms break into the top ranks in the former, and fewer employees are reported to have jobs with extensive freedom in decision-making--which is essential at companies engaged in novel, and thus creative, activity.

Further, I argue that the cause of that dearth of dynamism lies in the sort of "economic model" found in most, if not all, of the Continental countries. A country's economic model determines its economic dynamism. The dynamism that the economic model possesses is in turn a crucial determinant of the country's economic performance: Where there is more entrepreneurial activity--and thus more innovation, as well as all the financial and managerial activity it leads to-- there are more jobs to fill, and those added jobs are relatively

engaging and fulfilling. Participation rises accordingly and productivity climbs to a higher path. Thus I see the sort of economic model operating in the Continental countries to be a major cause-- perhaps the largest cause--of their lackluster performance characteristics.

There are two dimensions to a country's economic model. One part consists of its economic institutions. These institutions on the Continent do not look to be good for dynamism. They typically exhibit a Balkanized/segmented financial sector favoring insiders, myriad impediments and penalties placed before outsider entrepreneurs, a consumer sector not venturesome about new products or short of the needed education, union voting (not just advice) in management decisions, and state interventionism. Some studies of mine on what attributes determine which of the advanced economies are the least vibrant--or the least responsive to the stimulus of a technological revolution--pointed to the strength in the less vibrant economies of inhibiting institutions such as employment protection legislation and red tape, and to the weakness of enabling institutions, such as a well-functioning stock market and ample liberal-arts education.

The other part of the economic model consists of various elements of the country's economic culture. Some cultural attributes in a country may have direct effects on performance--on top of their indirect effects through the institutions they foster. Values and attitudes are analogous to institutions--some impede, others enable. They are as much a part of the "economy," and possibly as important for how well it functions, as the institutions are. Clearly, any study of the sources of poor performance on the Continent that omits that part of the system can yield results only of unknown reliability.

Of course, people may at bottom all want the same things. Yet not all people may have the instinct to demand and seek the things that best serve their ultimate goals. There is evidence from University of Michigan "values surveys" that working-age people in the Continent's Big Three differ somewhat from those in the U.S. and the other comparator countries in the number of them expressing various "values" in the workplace.

The values that might impact dynamism are of special interest here. Relatively few in the Big Three report that they want jobs offering opportunities for achievement (42% in France and 54% in Italy, versus an average of 73% in Canada and the U.S.); chances for initiative in the job (38% in France and 47% in Italy, as against an average of 53% in Canada and the U.S.), and even interesting work

(59% in France and Italy, versus an average of 71.5% in Canada and the U.K). Relatively few are keen on taking responsibility, or freedom (57% in Germany and 58% in France as against 61% in the U.S. and 65% in Canada), and relatively few are happy about taking orders (Italy 1.03, of a possible 3.0, and Germany 1.13, as against 1.34 in Canada and 1.47 in the U.S.).

Perhaps many would be willing to take it for granted that the spirit of stimulation, problem-solving, mastery and discovery has impacts on a country's dynamism and thus on its economic performance. In countries where that spirit is weak, an entrepreneurial type contemplating a start-up might be scared off by the prospect of having employees with little zest for any of those experiences. And there might be few entrepreneurial types to begin with. As luck would have it, a study of 18 advanced countries I conducted last summer found that inter-country differences in each of the performance indicators are significantly explained by the intercountry differences in the above cultural values. (Nearly all those values have significant influence on most of the indicators.)

The weakness of these values on the Continent is not the only impediment to a revival of dynamism there. There is the solidarist aim of protecting the "social partners"--communities and regions, business owners, organized labor and the professions--from disruptive market forces. There is also the consensualist aim of blocking business initiatives that lack the consent of the "stakeholders"--those, such as employees, customers and rival companies, thought to have a stake besides the owners. There is an intellectual current elevating community and society over individual engagement and personal growth, which springs from antimaterialist and egalitarian strains in Western culture. There is also the "scientism" that holds that state-directed research is the key to higher productivity. Equally, there is the tradition of hierarchical organization in Continental countries. Lastly, there a strain of anti-commercialism. "A German would rather say he had inherited his fortune than say he made it himself," the economist Hans-Werner Sinn once remarked to me.

In my earlier work, I had organized my thinking around some intellectual currents--solidarism, consensualism, anti-commercialism and conformism--that emerged as a reaction on the Continent to the Enlightenment and to capitalism in the 19th century. It would be understandable if such a climate had a dispiriting effect on potential entrepreneurs. But to be candid, I had not imagined that Continental Man might be less entrepreneurial. It did not occur to me that he had

less need for mental challenge, problem solving, initiative and responsibility.

It may be that the Continentals finding, over the 19th and early 20th century, that there was little opportunity or reward to exercise freedom and responsibility, learned not to care much about those values. Similarly, it may be that Americans, having assimilated large doses of freedom and initiative for generations, take those things for granted. That appears to be what Tocqueville thought: "The greater involvement of Americans in governing themselves, their relatively broad education and their wider equality of opportunity all encourage the emergence of the 'man of action' with the 'skill' to 'grasp the chance of the moment.'"

The most basic point to carry away is that the empirical results related here lend support to the Enlightenment theme that a nation's culture ultimately makes a difference for the nation's economic performance in all its aspects--productivity, prosperity and personal growth.

It was a mistake of the Continental Europeans to think that they expressed the right values--right for them. These values led them to evolve economic models bringing in train a level of economic performance with which most working-age people are now discontented. Perhaps the way out--to go from unsatisfactory performance to high performance--will require not only reform of institutions but also a cultural shift that returns Europe to the philosophical roots that put it on the map to begin with.

Mr. Phelps, a professor at Columbia University, is the 2006 Nobel Laureate in economics.

On the dangers of reductionism in economic analysis

By Donald Kalff

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The article by Edmund Phelps in the WSJ of Monday, February 12 is an attempt to investigate important intangibles that determine the performance of the American, French, German and Italian economies. He singles out European cultural values as the root cause of a lack of economic dynamism and performance. His argument is flawed for several reasons.

The first is that Phelps applies the wrong methodology. There are plenty of shortcomings in the structure and culture of European economies, as there are in the US economy, but the use of a single parameter as a basis of comparison between forms of capitalism that have developed over a century in different political, social and legal contexts will always fall short. Policies to improve matters based on a single explanation detached from its context will always fail.

Phelps detaches himself from the real world. He ignores the anomaly of the deep divisions in French society, politics and administration that prevent reform on the one hand and a thriving private sector on the other hand. The spectacular adjustment of the German private sector, particularly the "Mittelstand", to changed market circumstances, which among other benefits, produced an unprecedented drop in unit cost over the past five years, does not fit his worldview. Neither does he have an eye for the degree to which the Berlusconi government, self declared admirers of American capitalism, contributed to the poor performance of the Italian economy.

It would be more interesting to search for pattern type of explanations for each of the many forms of national or regional capitalism separately. Concerted efforts by historians, anthropologists, political scientists and institutional economists should help to deepen our understanding of our economies in all their facets. This will provide the foundation for coherent sets of policies to improve a region's well-being. Only moving along a broad front can do justice to the many inter- linkages in advanced economies.

Even within this bounded rationality Phelps builds on quicksand. His choice of Germany, France and Italy is arbitrary. A comparison with the Euro region as a whole, including Spain and the smaller highly

advanced economies, that, coincidence or not, are all closely tied to the German economy, would have produced a different picture.

Phelps restricts his scope further by defining economic performance as economic growth which occurs as a result of productivity improvement and the ability of a country to come up with new ideas, nourish these ideas and launch them in the market. Not many economists on either side of the Atlantic will support such a restrictive definition.

Even there Phelps is not on safe ground. His contention that the American economy is superior to the European is highly contestable.

It is now common knowledge that comparing US and EU economic growth rates is heavily distorted by differences in population growth and differences in key definitions. Over the years, the accounting rule that enables US companies to capitalize software expenses added 0.3% to US GDP. The US convention to take quality improvements into account lowered inflation by 0.3 % and, as a result, increases real GDP by the same percentage. Nobody speaks of the relatively high depreciation of assets by US companies that should depress GDP numbers but are nowhere reported. In this light the difference in headline numbers need to be corrected by somewhere between 1 and 1,5 %, generally putting the two economies on equal footing.

The differences in productivity growth between the US and Europe show up in very few economic sectors: "Retail", "Wholesale", "Financial Services", and "Production of ICT equipment". If differences between values play an important role one would expect improvement across all economic sectors. This is not the case. Moreover, shrinking Retail to its distribution function, ignoring the increase in working hours in Financial Services and outsourcing the production of components, inflate the picture.

Looking at real companies in real markets it will come as a surprise to many that the share of research intensive industries to total value creation in Europe is larger than in the US.

Focussing on the recent past, the performance of the US economy between 2000 and 2005 exceeded the European performance, even after the necessary corrections. However, growth was propped up by the very expansionist policies of the US Government and the Federal Reserve that kept consumer-spending going. Over this period taxes as a percentage of GDP dropped from 20% to 16%. In a roughly \$ 13 trillion economy this translated by the end of the period into an

additional \$ 500 billion cash to spend. Over the same period the US government increased its annual spending by \$ 400 billion, largely on homeland security and entitlement programs. Finally, artificially low interest rates and rapidly rising house prices enticed home owners to re mortgage their homes, and spend half the proceeds. In round numbers, this added another \$ 500 billion per annum. The combined effect, a Keynesian injection to the tune of 10% of GDP per annum would revive the most moribund of economies. Despite these very benign circumstances, and despite the well rooted US values and entrepreneurial spirit, the contribution of private sector investments to growth was very disappointing. The negative economic consequences of the resulting sharp deterioration of the balance sheets of the nation, the government and the US citizen will play out over the next couple of years.

If one chooses to study the dynamism of the US and European economies in a more productive way, the battle for world markets would provide interesting clues.

The companies of continental Europe maintain a trade surplus with the rest of the world, a large and structural trade surplus with the US, and are expanding aggressively and successfully in growth markets such as Eastern Europe, India and China. The very substantial rise of the value of the euro versus the yen and the dollar has only slowed this development.

European companies are building these positions despite the very substantial advantages their American competitors enjoy on their home market, which taken together provide an ideal launching pad for exports and foreign investments. To these advantages belong: only two business languages, one legal system, fully integrated markets across the board, structurally higher R&D spending, the world's most advanced ICT - and financial service industries, an abundance of venture capital, flexible labour markets and a widely supported political choice for economic growth over social cohesion.

European companies are doing well despite significant competitive disadvantages. To some extent these mirror American advantages. The Euro zone alone remains the home of 13 legal systems and 13 tax codes, almost as many languages, different labour laws and practices, different roles of regional and local authorities, different forms of environmental protection, different consumer protection, and so on. In addition, European companies still have to overcome a range of barriers to broaden their base within the EU. Export of goods has been

a success, but the export of services is still at pitiful levels. The number of European companies with a significant presence on the ground in another European country runs only in the thousands among millions of companies. Overall, European economic integration is far less advanced than generally assumed which puts an even brighter light on its competitiveness on world markets.

This points to the need to identify the historical developments, government institutions and policies, and corporate governance and practices that in combination amount to European strategic advantages which hitherto have not been identified as such and that deserve to be protected and enforced. This will also help to highlight weaknesses in the American economy and subsequently the identification and implementation of remedies.

Progress in both economies will require very different combinations of internally consistent policies, institutional reform and shifts in underlying values.

Nobel Simplism

By Donald Kalff

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The Feb. 12 editorial feature "Cultural Matters" by Edmund Phelps is an attempt to blame European Values for the Continent's perceived lack of economic dynamism and performance. Mr. Phelps's argument is flawed for several reasons. Even if one accepts that economies can be compared on the basis of growth alone, the author's contention that the U.S. economy is superior to Europe's is highly contestable. Comparisons of growth rates are heavily distorted by differences in definitions of key variables. Once corrected for the different inflation measures used on both sides of the Atlantic and the way corporate software investments are treated in national accounts (as a cost in Europe, as an asset in the U.S.), the real per capita GDP growth of the two economies has been very similar over the past two decades.

Between 2000 and 2005, the U.S. economy did outshine Europe, even after the necessary corrections. But growth was propped up by exceptionally expansionist government and Fed policies. Yet despite these stimulating circumstances, and despite the U.S. values of entrepreneurial spirit, the contribution of private-sector investments to growth was disappointing. And the resulting deterioration of the current account deficit will burden the U.S. for years. Moreover, the use of a single parameter as a basis of comparison between different forms of capitalism that have developed over a century in different political, social and legal contexts will always fall short. Policies based on a single explanation detached from its context will fail.

It would be more productive to search for multifaceted explanations and patterns for each of the many forms of regional capitalism. Concerted efforts by historians, anthropologists, political scientists and economists should help to deepen our understanding of our economies. Studying the dynamism of economies in the battle for world markets can provide interesting clues. The economies of continental Europe maintain a trade surplus with the rest of the world and a large and structural trade surplus with the U.S. Meanwhile, American companies enjoy many competitive advantages over their European competitors, such as fully integrated markets, higher R&D spending, the world's most advanced ICT and financial service industries, flexible labor markets. This amounts to the most superior launching pad for exports imaginable. The question is why this

potential remains untapped? The explanation will be infuriatingly complex, but it would serve policy makers well.