Financial Columnists

Dynamism or Stasis

Virginia Postrel 11.27.06, 12:00 AM ET

It's heresy to say so in these pages, but the sluggish economies of continental western Europe have far bigger problems than high tax rates and big welfare states. The economic policies of countries like Germany, France and Italy have gone wrong in ways that cutting taxes and tightening social insurance can't fix.

The hardest of all economic problems is what to make next. What's valuable that hasn't been done before? Businesses, and whole economies, can only grow so much by copying or incrementally improving what's already been done. For significant growth to continue, innovators have to come up with new and valuable ideas. Mere invention isn't enough; the novelty has to be something customers want.

European corporatism, dating back to the 1920s, stifles that process. This ideology's goal: "Remove the brain of capitalism to curtail and modify the mechanism of experiments and discoveries undertaken by unorganized entrepreneurs and financiers and replace it with a selection mechanism governing investment and innovation that would require a consensus of key social groups." These are the words of this year's Nobel laureate in economics, Edmund S. Phelps of Columbia University, in a 2005 working paper. Google: Phelps, "The Economic Prosperity of Nations.")

What the stagnating economies of western Europe need, Phelps suggests, is more "dynamism," a term I used in my 1998 book *The Future and Its Enemies* to describe much the same process of decentralized experiments.

Economists and policymakers, he argues, should focus less on neoclassical prescriptions--tax and spending incentives, inputs of labor, capital and physical resources--and more on barriers to dynamism. With the right incentives and input, an economy can indeed grow rapidly, but that works only as long as there are plenty of good ideas for businesses to copy from other places, whether for cloth in 19th-century America, cars in 20th-century Japan or shoes in 21st-century Vietnam.

Phelps attributes Europe's postwar takeoff to "a rapid injection of new technologies" invented elsewhere and financed by private capital coming largely from the U.S. "The foreign aid of the Marshall Plan was small next to the private capital that helped fuel the Continent's catch-up miracles," he writes in "Understanding the Great Changes in the World: Gaining Ground and Losing Ground Since World War II," an article just published in the online journal Capitalism and Society. As for supply-side arguments, he notes a timing problem: tax cuts in the late 1940s but rapid productivity growth only in the late 1950s and 1960s.

And that's all ancient history. For the past decade, writes Phelps, "most of western continental Europe has been gripped by a new slowdown, one that has brought the productivity growth rate far below the rate enjoyed by Americans and most others in the world's population--those in China, India, South Korea, Scandinavia, central Europe and Ireland, to name most of the buoyed up populations."

The conventional focus on taxes and spending, Phelps argues, is distracting policymakers from more fundamental barriers to innovation, such as Germany's protected small regional banks or its requirement that trade unions have a say in companies' investment decisions.

"[Chancellor Angela] Merkel of Germany really got off on the wrong foot by thinking that the villain of the piece is the welfare state when she should be worrying about all those things that she seems to think are just fine," he says. Cutting taxes is of limited use when German laws keep capital from flowing to the most promising new ideas, at least within the country.

Corporatist barriers can not only reduce the chances of truly original innovations but also slow the adoption of best practices developed elsewhere. "Average practice on the Continent responds far more slowly to a given increase in best practice than does average practice in the U.S., owing to a range of burdens and barriers present on the Continent," he writes.

Continued growth and prosperity require more than incentives to work, save and invest in the same old ways. To grow beyond the frontier of imitation, an economy must foster a constant flow of economic experiments. But these are the very sorts of disruptive enterprises that threaten the neat arrangements of the corporatist status quo. You can't have growth without dynamism, which is another word for change.

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