

## THE EUROPEAN LABOUR MARKETS

### THE SEARCH FOR ROUTES TO BETTER ECONOMIC PERFORMANCE IN CONTINENTAL EUROPE

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Economic performance is multi-faceted. Productivity and unemployment in a country are the headline indicators of its economic performance. They serve to summarize a variety of more basic considerations. High productivity indicates that wage rates are high in a wide range of jobs, so a wide choice of careers is open to people, and that incomes are high, so that people can afford the comforts, the diet, and so forth needed to function well. A low unemployment rate indicates that members of the labor force can readily find vacancies in a wide range of jobs, few employed people are quitting their jobs out of dissatisfaction, and few jobs are short-lived.

Labor force participation is an indicator in another dimension of economic performance. Uniformly high labor force participation rates are a sign that a generally high value is being placed on existing jobs and the wages they pay. In addition, participation rates are an indicator of another dimension of economic performance often called economic inclusion – inclusion in the mainstream economy: For one thing, they may reflect the extent to which mainstream jobs provide people with economic independence from the family and from the state. They may also reflect the degree and breadth of the access to mainstream jobs, thus indicating the country's success or failure in removing barriers to inclusion.

More needs to be said about the conception of economic performance. As many philosophers have argued, building on Aristotle, an economy cannot be

said to be well-performing if its participants are not flourishing. And that deep kind of prosperity entails that the available jobs are, on the whole, intellectually engaging and rewarding: That means a wide availability of work enlisting the minds of jobholders, offering challenges in problem solving, leading them to discover some of their talents and causing them to expand their abilities. And from the discovery and development of talents and capabilities comes what is called personal growth.

Direct measurements of such discovery and development are difficult, of course. It is reasonable, however, to suppose that an increase in such personal growth (from one era to another or from one country to another) is signaled by an observable increase in participation rates, reduced employee turnover and thus reduced unemployment. So the degree of prosperity in the above sense may be well *proxied* by the level of business activity – the participation rate, the unemployment rate and the activity rate.

The main national statistics on economic performance, therefore, may be said to be normally indicative of the underlying health of the economy they describe – just as measurements of a patient's weight, blood pressure, etc. are normally indicative of the patient's health. But the statistics of a very healthy economy may have statistics with some "false positives" leading incautious observers to believe that the economy is sick and in need of reforms when it is merely suffering from bad external shocks. And an unhealthy economy may at times enjoy favorable winds giving it great-looking statistics with "false negatives" that conceal its unhealthy structure. So we must use the always interesting "indicators" judiciously if we are not to be misled. Thus, in comparing recent national statistics with the glorious statistics in the 1960s, we must not jump to the conclusion that western continental Europe had well-performing economies then, relative to the rest of the OECD, and now they are worse-performing. Indeed, we believe (and have adduced evidence) that some unusual market forces were almost certainly the main driver of the glorious statistics – not a brief golden age of economic policies, economic



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institutions and economic cultural influences.<sup>1</sup> If so, it is the *inglorious* years of the past ten years or so, especially the mid-1990s, when all the OECD economies were more nearly in a steady-growth state, that better reveal the true relative health of the Continental economies, not the glorious years. (Whether in fact the structure of the western Continental economies has worsened on balance and, if so, by how much is far from clear.)

Our question here is the following: If we are not mistaken, a great many Europeans sense that the economic performance of their economies as structured at present could be greatly improved. We agree that, in principle, their economic policies or economic institutions or both could be changed for the better. But which changes does actual evidence suggest would deliver better performance? We distinguish three points of view on the question, which we will discuss in turn.

Current efforts in some countries to lower taxes on labor may miss the essential points

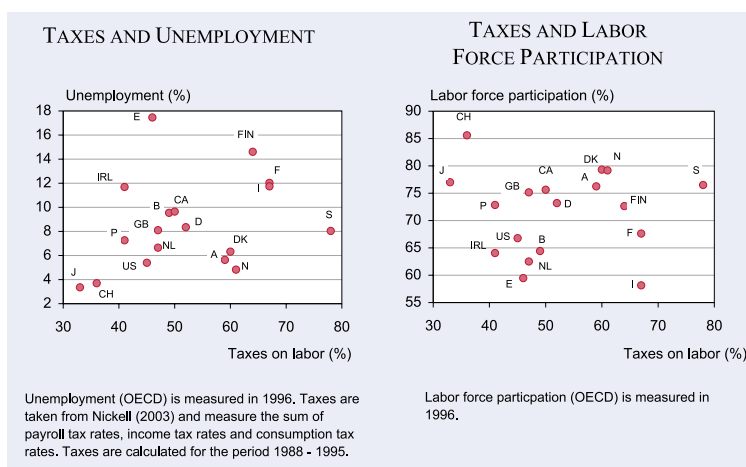
#### Does the neo-liberal/supply-side critique point the way?

If a huge part of an advanced economy's potential performance is the stimulus and challenge presented by jobs and the consequent discovery and development of talents – a possibility requiring the economy to be structured for well-aimed innovation – we should be prepared to find much, and very likely most, of the sources of high performance embedded in the part of the economy's structure that determines the opportunities for problem-solving and personal growth in the workplace – hence, in economic institutions operating in the Continental countries and perhaps even in their economic culture – and relatively little in that part of the structure involving the calibration of tax rates and benefit rates.

In contrast, neo-liberals and supply-siders put their faith in reduced rates of tax and better tuning of var-

<sup>1</sup> Since industries on the Continent had done relatively little to improve the techniques in use during the 1930s, when the United States streaked ahead, and during the war and reconstruction in the 1940s, their opportunity in the 1950s and 1960s to adopt the American methods made possible a period of phenomenal technical progress.

Figure 1



ious other policy parameter settings. Supply-siders assert that ill-considered increases in the average tax rate on personal income and in the social contribution levied on company payrolls are a major reason for the elevation of unemployment rates and the depression in participation rates.

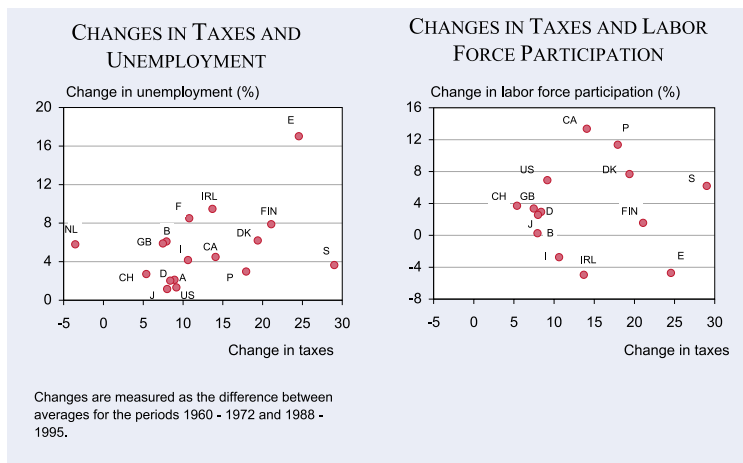
Is there evidence that these policy settings are an important cause of poor performance and their correction an important cure? The fact that tax rates rose when – or before – unemployment rates rose on the Continent is not persuasive, since a great many other developments coincided with the rise in unemployment. To obtain some estimate of the effect of a tax rate increase or decrease on unemployment it is natural to conduct a more demanding test: to ask whether in the present era (or in an earlier one) inter-country differences in unemployment rate among the advanced economies of the OECD members appear to be explained in part by inter-country differences in, say, the total tax rate on labor.<sup>2</sup>

Figure 1 suggests that, within a considerable range at any rate, an increase of the average tax rate has rather little effect on unemployment. Even the very high-tax economies of Denmark and Sweden do not have relatively high unemployment and low participation. Neo-liberals may reply that many high-tax countries happen to have some compensating conditions avert high unemployment and low participation.

A further test is to ask whether inter-country differences in the increase of the tax rate on labor occur-

<sup>2</sup> The failure of some of the explanations critiqued here were noted in Phelps and Zoega (1998).

Figure 2



ring between some early time span after the war and a more recent span are strongly correlated with inter-country differences in the increase of unemployment and the decrease in participation.

Figure 2 suggests that, within the historical range, decadal changes in countries' average tax rate have little or no explanatory power in accounting for the decadal changes in their unemployment and participation rates. And some of the small effect that appears in the charts may be temporary, not permanent.<sup>3</sup>

Such findings do not establish that tax rates do not matter at all. We firmly believe, speaking for ourselves, that increases in tax rates on wage income in particular, such as payrolls, have temporary effects on the medium-term natural unemployment rate – the rate toward which the equilibrium unemployment will be approaching over some near-term span, barring new shocks (Phelps 1994).<sup>4</sup> But we also believe that, if the pace of wealth accumulation decreases in response to reduced after-tax pay (as in all but so-called Ricardian models), the decline of private wealth onto a lower path will tend to erase

<sup>3</sup> There is no significant relationship (the correlation is 0.14) between the two variables when Spain is omitted from the figure. Its inclusion creates the appearance of a relationship (correlation is 0.39). Whether to infer that tax hikes might be to blame for a significant part of the durable increases in the OECD unemployment problem then hinges on whether Spain's unemployment increase can be attributed to increased taxes. Time series data show that taxes in Spain rose continuously and smoothly from 1960 into the 1990s while unemployment rose rather abruptly after 1975, peaking in 1985. Thus we would not agree that Figure 2 supports supply-siders ascribing the increases in relative unemployment in some countries to increases in those same countries' relative tax burden. A convincing analysis will have to be detailed and sophisticated.

<sup>4</sup> Incidentally, the charts here pick up some of the temporary effect of tax rates, since, until recently, most OECD countries kept on increasing their tax rates, thus continually giving an upward jolt to unemployment. So some of the already very small effect of tax rate increases on unemployment depicted in the charts is not a permanent effect; the latter is even smaller than the charts suggest.

much of the short-run effect. The reason is that what matters for the amount of labor supplied and for employee loyalty – quitting, shirking, and other behavior determining the amount of unemployment – is not the absolute wage but the wage as a ratio of the workers' wage to their accumulated wealth (or the cash flow from it). The existence of a permanent effect thus depends on a failure of wealth to fall ultimately in proportion to after-tax wage rates.<sup>5</sup> This failure is likely, since wealth

includes social wealth – the present discounted value of the entitlements provided by social legislation – as well as private wealth; and there is no reason why social wealth should fall at all merely because a tax increase has driven down private wealth. In fact, recent decades have seen tax rates increased for the express purpose of *increasing* social wealth; where the unemployment rate rose following the legislation, the tax increase was blamed when, in truth, the increase in social wealth was responsible.

In view of our theoretical strictures above, it will not be surprising to learn that the tax rate used above does little better in explaining differences in productivity either.

Another policy parameter that has been the focus of the neo-liberals is the “replacement ratio”, giving the proportion of the wage earnings that will be replaced with benefits if a wage earner loses his job. In theory, an employee who can expect a high replacement ratio has a diminished stake in his employment: he may invest less in his job and may shirk his duties and quit more readily as a result (Summers 1988). Others have emphasized the incentives of the unemployed (Nickell and Layard 1999). Wage replacement delays and weakens the job loser's willingness to accept a new job and to search for one – the more so the higher is the replacement ratio.

<sup>5</sup> In theory, the average tax rate on wages would be entirely neutral in the long run, in theory at in any rate, if the legislature were to keep workers' social wealth in fixed proportion to their after-tax wage rates. Then private wealth and total wealth would ultimately decrease so as to regain their former ratio to after-tax wage rates and in so doing restore the medium-term natural unemployment rate to its previous level.

What matters is the ratio of wealth – social and private – to after tax wage rates

Figure 3

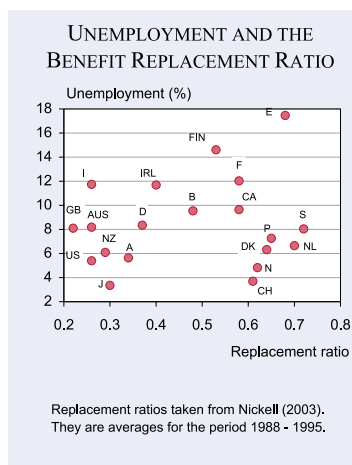
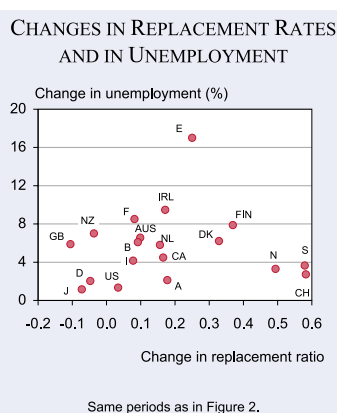


Figure 4



However, Figure 3 does not show a significant correlation across OECD nations between the replacement ratio and unemployment in the mid-1990s.<sup>6</sup>

Figure 4 finds no apparent relation between the increases from the 1960s to the 1990s in the decadal replacement ratio and the increases in the replacement ratio.

We ought to consider whether the influence of taxes and replacement rates is present but masked by omission of other possibly important variables having influences. Nickell (2003) and various co-authors have sought to explain differences in OECD unemployment with a package of hypothesized variables alongside taxes, the replacement ratio and its duration. That package did a good job of fitting the inter-country differences in unemployment of the 1970s and 1980s. Nevertheless, it did not do a good job of fitting the differences of the 1990s nor the 1960s. As we see it, the former two decades yielded favorable results because the early years in both those decades saw an explosion of job losses; and replacement benefits (both level and duration) played a part in determining how slowly the bulge of jobless persons was digested into employment over the decade; in contrast, the mid-1990s and the mid-1960s look more nearly like a steady-state situation. Furthermore, the movements of the package over the decades do not generally explain why unemployment rose in many countries between the 1970s and the 1980s and fell in some countries between the 1980s and the 1990s.<sup>7</sup>

<sup>6</sup> Again, Spain is an outlier and has both high unemployment as well as a high value of the replacement ratio. But in this case its inclusion is not enough to raise a question about the inference to make from the chart.

Research in the supply-side spirit has been expanded in the last decade to include the dial-setting of numerous other “policy variables” appearing in neoclassical models – variables not theoretically doomed to have little permanent effect. We might mention here our own work estimating the effect of our social wealth (or social income) variable upon one dimension of economic performance, namely the unemployment rate (Phelps and Zoega 1997). It can be reasonably said that the estimated effects on economic performance measures of these further supply-side forces – social wealth, public expenditure (i.e., government purchases), private-sector capital stock, public capital stock, corporate profits tax rate and so forth – have been disappointingly small, even if sometimes statistically significant.

If our conception of the advanced economies is one centered not around consumption and leisure but instead around the attractions and rewards of business life – problem-solving, the discovery and development of talents, and the achievements that may result – then it is not surprising that these policy parameters, though important in the neoclassical perspective generally adopted by supply-side analysts, do not make much of a dent on unemployment and participation – as long as they stay in the historical range. It becomes hard to see why the neoclassical preoccupations with work-leisure substitution should be center-stage. Reducing the calibrations of the welfare state or cutting government purchases or adding to capital stocks will not make jobs far more engaging and rewarding, hence make participation in the labor force far more attractive and unemployment far smaller. Only modest results can be reasonably hoped for. That may be why the plan of the European Commission to add to the Continent’s stock of bridges and tunnels struck many as a sort of joke, even if they could not put their finger on why it was funny. It appears unlikely that more bridges and tunnels on the Continent will contribute measurably

<sup>7</sup> Using differences, as in Figures 2 and 4 above, we estimated an equation where changes in unemployment for 14 OECD countries were a function of changes in the tax rate, replacement ratio, the duration of benefits, and so forth. When estimated this way, most of the coefficients have counterintuitive signs and many are statistically insignificant.

The size of unemployment benefits and their duration also fail the test

to the sense of prosperity that those countries are so acutely and visibly missing. If that is so, they will probably have negligible impact on participation and unemployment. And it is doubtful they will be productive enough to repay their capital cost.

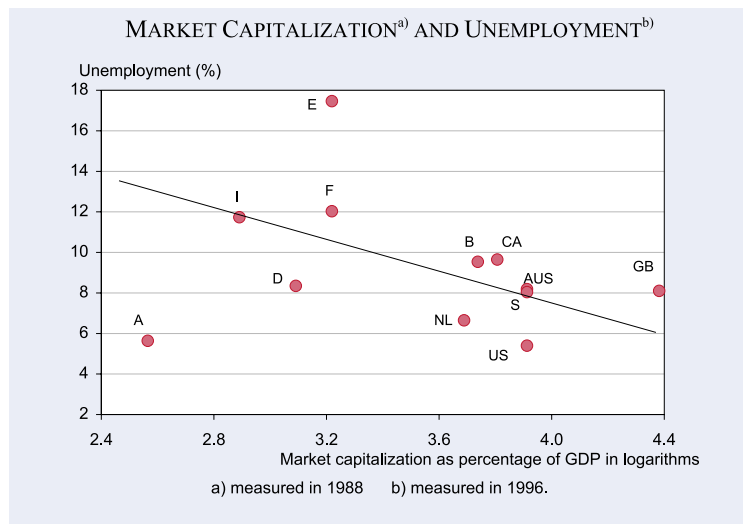
### The importance of economic institutions for dynamism

The thesis has been advanced that what may be called economic dynamism – innovativeness coupled with a financial sector capable enough to choose reasonably well the innovations, firms and investments to support – is a force that powerfully lifts economic performance in all its main dimensions: participation, joblessness and productivity.<sup>8</sup> Though not itself a dimension of performance, this dynamism is the fuel, the energy, on which stimulation and problem-solving in business, thus prosperity, and well-directed innovation, thus relative productivity, feed.

There is circumstantial evidence that dynamism is hugely important for the performance. It is plausible to assume that a high value placed on the equity shares traded on the stock market is a sign of high dynamism in the business sector. Dynamism either drives share prices to a higher level, since extant firms represent a kind of option to exploit the valuable future opportunities that a dynamic economy fosters, or it causes an increased proportion of firms to list their shares on the organized stock exchange. It therefore strongly supports our thesis that, among 11 large OECD nations, differences in the level of market capitalization taken as a ratio to GDP – even the level many years prior to the year of the measured performance – have considerable power to explain differences in productivity, in participation and in unemploy-

<sup>8</sup> The thesis was introduced in Phelps and Zoega (2001), developed further in Phelps (2001), and expanded upon in Phelps (2003b).

Figure 5



ment.<sup>9</sup> See Figures 5, 6, 7 and 8. Two of these correlations have more explanatory power than all the neoclassical variables put together. Readers used to focusing on labor market features may be surprised. Yet, so broad a concept as dynamism is bound to encapsulate goods, capital and labor markets.<sup>10</sup>

What institutions appear to matter for inter-country differences in performance? Presumably there are some economic institutions the presence and high development of which serve to encourage or facilitate dynamism. It is reasonable to hypothesize that organized stock exchanges, company law, suitable bankruptcy provisions, and corporate governance

Dynamism, as proxied by market capitalization, has great explanatory power

<sup>9</sup> See the latter two charts in Phelps (2003a).

<sup>10</sup> In Figure 8 we first adjust productivity for differences in the employment-to-working-age population ratio.

Figure 6

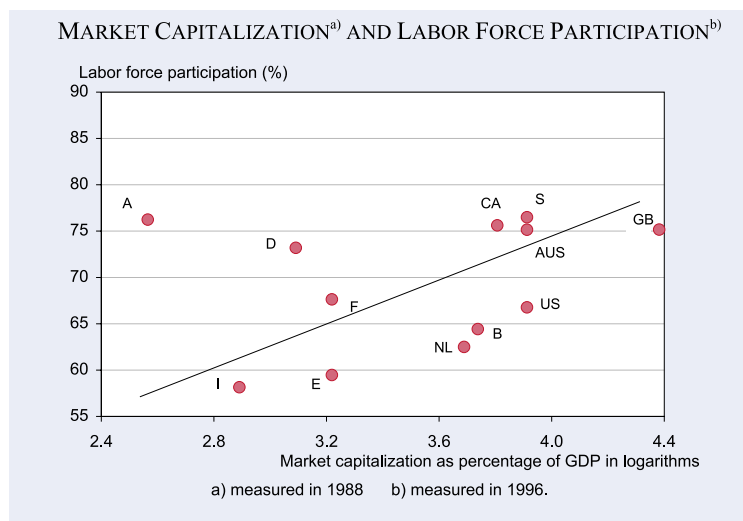
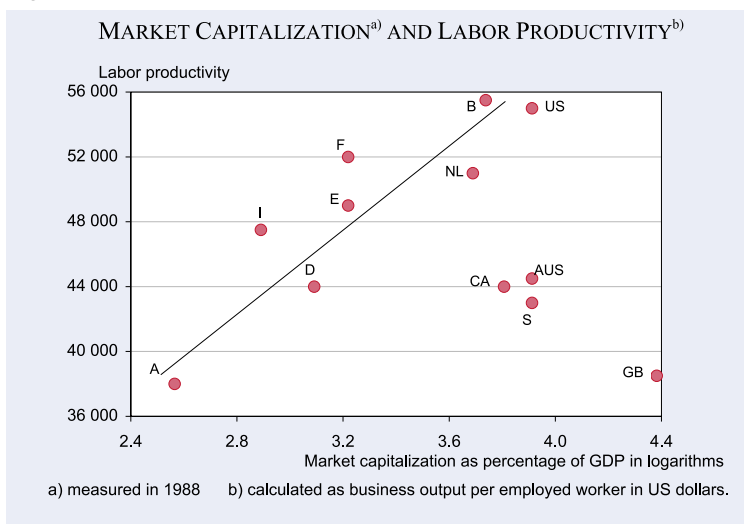




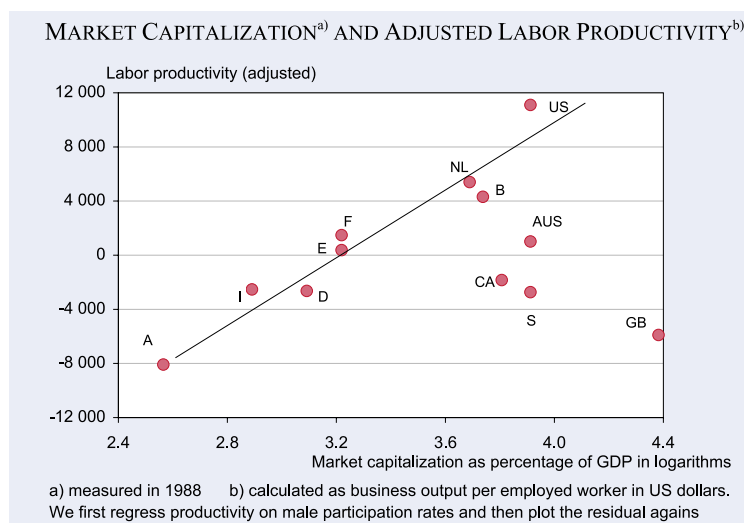
Figure 7



spurring corporate performance, and schools preparing the population for business life all foster dynamism. General institutions such 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; but they are not sufficient to generate dynamism.<sup>11</sup> Presumably there are also economic institutions whose presence and force obstruct or impede dynamism. Corporatist institutions that invest company employees, labor unions, communities and other interest groups with the veto power to block or limit entrepreneurial ventures and shifts in

<sup>11</sup> To say that is in no way to depreciate the pioneering work of Douglass C. North in arguing the near-unworkability of an economy not supported by property rights and the influential research by Andrei Shleifer devising persuasive evidence in support of this thesis.

Figure 8



corporate operations may choke off valuable innovations, dampen entrepreneurial spirits and thus decrease dynamism. The task is to identify the institutions that foster dynamism and those that obstruct it; and to investigate their empirical contribution to performance.

Research of ours a few years ago implicated some institutions in the failure of most European economies to grasp the opportunities of the internet revolution of the late 1990s – bureaucratic “red tape” and employment protection legislation were among

these – and the findings credited some institutions with helping some of the other OECD economies with seizing the new opportunities – a relatively high proportion of the labor force with a university degree, for example (Phelps and Zoega 2001). In more recent research we have been looking at specific institutions in the corporatist landscape to see whether some of them are, statistically speaking, harmful for economic performance. The explanatory variables are the degree of employer- and union-coordination in the industrial bargaining process, here weighted by the extent to which wages are “covered” by union scales, the penalty for employee dismissal provided in employment protection legislation;<sup>12</sup> also, the volume of required licenses hindering or deterring the establishment of new firms and new projects, as measured by the OECD index of “red tape”. Our highly tentative findings suggest that the effects of these institutions are harmful for market capitalization, which is a strong sign that they are harmful for economic performance.

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### Is economic culture an important primary cause?

Continental Europe has been languishing more than two decades since the shocks of the late 1970s. Southeast Asia, China and India now exhibit enormous

<sup>12</sup> See the first two charts in Phelps (2003a).

Table 1

Market Capitalization Ratio and Economic Performance

Regressors	Dependent variables			
	Unemployment	Participation	Labor productivity	Labor productivity (adj.)
Market capitalization ratio	-4.18 (2.1)	9.06 (2.2)	4539.4 (1.4)	7591.8 (3.3)
Labor force participation (men)				-76419.2 (3.2)
R-squared	0.33	0.35	0.33	0.60

Notes: Market capitalization is the value of shares in the corporate sector as a fraction of GDP in 1988 (Morgan Stanley International). Labor productivity is calculated as business output per employed worker in US dollars. All dependent variables are 1996 values. t-statistics in parenthesis.

energy and initiative, whatever support and impediments are brought by their economic institutions. Some economists have speculated that differences in economic culture, even among the advanced economies of the OECD members, may play some *part* in the inter-country differences in current-day performance statistics.

Do elements of a distinctive economic culture on the Continent somehow impede the generation of dynamism and thus lessen its economic performance in terms of participation, unemployment and productivity? Europeans themselves have suggested that there is. In some Continental countries there is an expressed uneasiness about making money. As Hans-Werner Sinn said to one of us, a German would rather say that he inherited his wealth than say that he had made his fortune. There is the practice on the Continent of shielding teenagers from any sort of job experience or earning any money, so that the business world must seem rather foreign to them as they are growing up. Some observers have suggested that European schooling drains children there of some of their playfulness and creativity. Some Belgian businessmen were heard to say that they thought Europeans were more risk-averse than Americans. It has been said that the protection of European culture has effectively meant sheltering older and more established figures from competi-

tion, which may cause competing and upsetting the established order to be viewed as wrong. (None of these speculations implies that Europeans are deficient in some sort of genetic material. Americans, too, are largely of European stock.)

Critics say that these seeming deficiencies are not causes – they are effects of ill-chosen institutions. Yet, what are the causes of the institutions if not the prevailing political economy, on which culture may have much influence.

#### Conclusions and a side-issue

We agreed with the Europeans who sense that the performance characteristics of the Continental economies as currently structured leave room for improvement. We went on to argue that the most effective means to improvement do not appear to be those in the neoclassical liturgy: smaller welfare entitlements, reduced public expenditure, and so forth. The conclusion to which we have been tending is that the Continent's performance will be markedly *better* if it will nourish and promote (more than it is already doing) entrepreneurial and financial institutions that encourage and facilitate dynamism and if it will remove or reform the institutions that obstruct entrepreneurial activity and well-chosen financing.

Of course, identifying with adequate confidence the many concrete institutions that are helpful and those that are harmful is a daunting task, yet some first steps can already be seen as warranted on the evidence.

But how – choosing our time period of observation carefully to avoid years or decades of

Economic culture affects the political economy which influences the institutions

Table 2

Economic Institutions and Dynamism

Dependent variable: Market capitalization					
Coordination	-9.25 (1.6)	Employment protection	-10.50 (1.9)	University degrees	0.98 (1.9)
R-squared	0.73	Observations	19		

Notes: Union coordination and employment protection are taken from Nickell (2003) and represent averages for the period 1988–1995. University degrees show the proportion of the labor force that has completed university for the same period. t-statistics in parenthesis.

Table 3

## Measures of Economic Performance

	Market output per hour worked	Wage share of business output in %	Men in labor force in % of work.-age men	Employment in % of labor force
US	100	49.5	87	94.6
France	92	42.3	75	88.1
Germany	92	52.4	82	91.3
Italy	–	46.9	74	88.5

Market output per hour worked is for 1992 (Solow/Bailey); wage share is calculated for year 2003 (OECD); and men in labor force and employment are measured in 1996 (OECD).

unusual market forces – does Continental performance generally rate gauged against the performance measures of the US economy? Is Continental performance already relatively *good*? Is it inferior in some respects and superior in others? Or what?

In Table 3 we show some estimated measures of economic performance in its various aspects for the three large Continental nations – Germany, France and Italy, the so-called “big 3” – and the United States in the steady mid-1990s.<sup>13</sup> One of the table’s columns quantifies the familiar fact that the unemployment rate is considerably higher among the big 3 than in the United States. These 1996 data do not differ markedly from the rates in late 2003 and early 2004.

Another column addresses the belief that women choose not to work on the Continent but men, having as much aspiration for self-realization as American men, have the same participation rate as American men. The data shows that, to the contrary, even the participation rate of men is lower in the big 3.

Another column addresses the vexatious issue of relative productivity on the Continent. The productivity estimates shown are those from a careful study by Solow and Bailey (2001) using 1992 company data from McKinsey & Company. These estimates suggest that, contrary to widespread belief in Europe, even *hourly* productivity in the big 3 is significantly below that in the United States. Their measurements of output per unit of capital in Europe relative to the United States were even lower. In the ten years since that study the productivity gap has widened, most strongly since 1997. According to some experts on productivity data, the gap would be markedly greater if an adjustment were made for the workers of low

capabilities who are allowed to work in the American business sector but who are barred from such jobs in Europe by labor regulations, minimum wage laws.<sup>14</sup>

Moreover, in both France and Italy the wage rate gap is worse than the productivity gap, since workers there receive a compressed share of their productivity. As a result, the French and Italian average hourly wage in terms of goods produced is more depressed relative to the United States than is productivity. (The reverse appears to be true in Germany. It may be that business output in Germany is more composed of high-wage engineering goods than in other countries.)

If these estimates are to be believed, the performance of the Continent’s big 3 economies does not compare favorably in any respect to those for the United States.

This finding, to the extent the many Continental economies conform to it, fits into the theme of this report. The finding suggests that the Europeans are right who say that there is much room for improving the performance characteristics of the Continental economies. The Continent’s relative productivity performance is not a plus; certainly it does not redeem the poor performance on the other measures. Furthermore, the finding that the Continental economies tend to perform less well on all measures (and in any case not better on some) adds support to our belief, argued here, that the high joblessness in the Continental economies – most notably, the large ones – is just one manifestation of a systemic pathology harming economic performance in all its dimensions: Work is central to life and the quality of work is a telling sign of the health of the economy’s structure. The active-age population can flourish only

<sup>13</sup> As commented above, the mid-1990s were not severely and differentially disturbed by unique shocks such as the Continent’s strides toward technical catch-up in the glorious years and the extraordinary investment boom that gripped the United States and left the big 3 on the Continent relatively untouched.

<sup>14</sup> It is not true, incidentally, that the Solow-Bailey calculations have already adjusted for inter-country differences in the extent to which businesses in some countries use far more “less qualified” labor than do others. These results for France are discussed in a recent paper by Blanchard (2004).



with change, excitement and challenges in the workplace. Underdevelopment of the institutions encour-

aging and disciplining entrepreneurs and their financiers leads ultimately to diminished stimulation

at work and lessened personal growth on the job, which are signaled by lower participation rates and higher unemployment. Artificial barriers to entrepreneurship and thus to innovation lengthen the technological lag behind best-practice levels in the world and thus to relatively low levels of productivity.

Figure 9

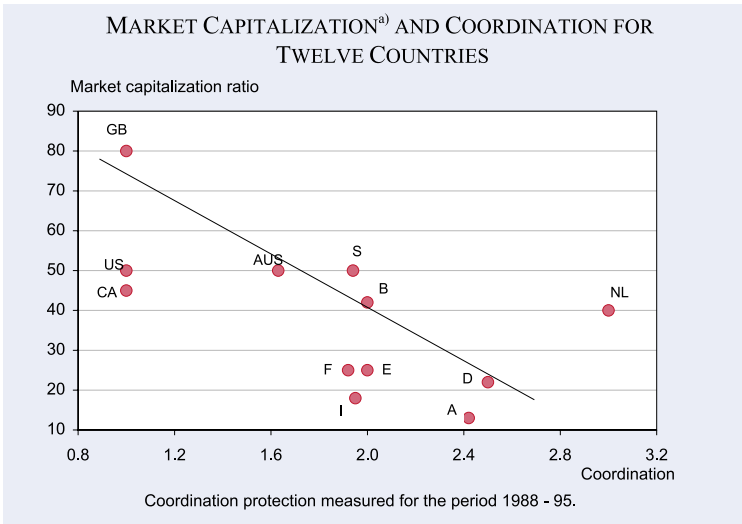


Figure 10

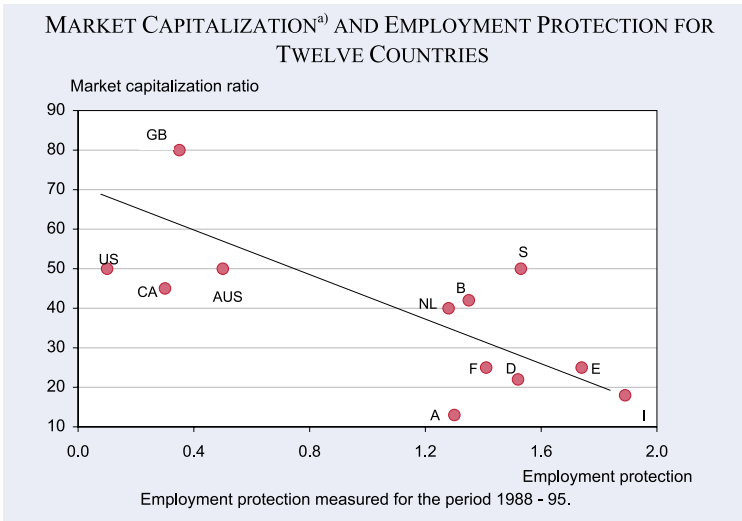
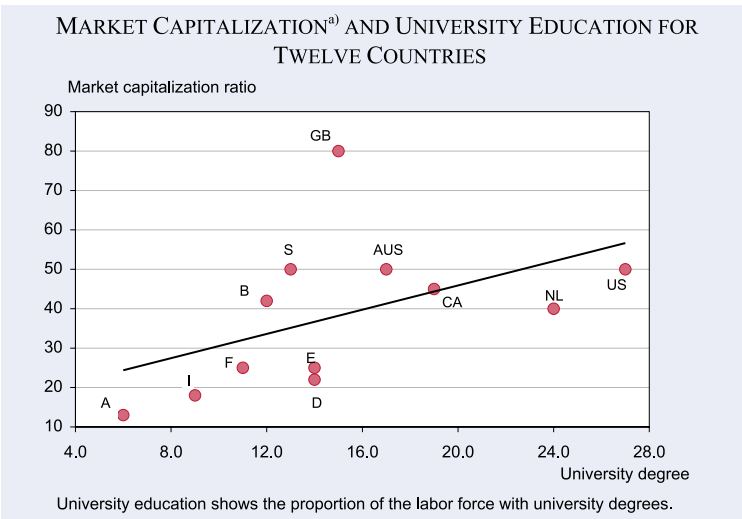


Figure 11



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Institutions encouraging entrepreneurs and excitement in the workplace are the solution