



Edmund Phelps: HOW ECONOMIES FLOURISH

EDMUND PHELPS is one of the great economists of the mid-to-late twentieth century and author of the widely acclaimed *Mass Flourishing* (Princeton University Press 2013). Here, the Nobel Prize winning economist discusses unemployment, economic dynamism and Europe's long term economic outlook with the IEA's Editorial and Programme Director, **PHILIP BOOTH**

Much of your early work was in relation to the Phillips curve and unemployment. Indeed, it was for this work that you won the Nobel Prize. What was your key insight about the trade-off between inflation and unemployment?

The key insight was this. If, for example, a firm was trying to keep its wage competitive in order not to have to hire replacements who it would need to retrain, it would be constantly raising its wage in order to keep pace with what it thought to be the rate of growth of wages in its industry. That would mean that there would be no unbreakable link between "wage inflation" and unemployment.

If the firm expected there to be inflation, it would increase its wages and any effect of inflation on reducing unemployment would only be temporary as the cost of hiring new workers would increase.

Unemployment is therefore mainly determined by other factors and cannot be "traded off" against inflation.

I also integrated the idea of "efficiency wages" into macro-economic theory. Firms might increase wages in order to improve motivation and reduce labour turnover. The higher wages would generate an excess of supply of labour – and could lead to higher productivity in particular circumstances.

If there is no trade-off between inflation and unemployment, what are the main determinants of unemployment in the long run?

Some important determinants are the propensity of employees to quit, their propensity to shirk, and the size of the area over which unemployed workers are spread.

In the EU, or in any economic union, there are also the influences

coming from neighbouring countries. Basically, unemployment is determined by how well the labour market is functioning.

Many countries in continental Europe have had chronically high unemployment for some time, what should they do to try to reduce unemployment?

In 1973 I argued the importance of keeping the inflation rate up. In 1997 I argued that governments could – and should – pay subsidies to employers based on the number of low-wage workers in their work force. But these things may not resolve long-term structural problems.

In my 2014 book there is the suggestion that an economy of high dynamism has a tendency on that account to have high employment through a couple of mechanisms. In general, brilliant economies don't



BRILLIANT ECONOMIES DON'T HAVE A LOT OF UNEMPLOYED LABOUR LYING AROUND

have a lot of unemployed labour lying around.

Your new book, Mass Flourishing, looks at the sources of economic dynamism and progress. Currently the UK is experiencing what is often termed a "productivity crisis" so this is perhaps especially relevant to us. What have you discovered during the course of your work about the causes of the vitality of the US economy in the twentieth century?

As in any country, Britain's "progress" – the rise in the mean levels of productivity, wages and wealth – depends heavily on new and better products and production methods in the rest of the world.

Mass Flourishing takes a different course and has a series of themes.

I prefer to focus on individual prosperity and flourishing – and their inclusiveness. I think of "prospering" as acquiring *material* gains through one's efforts and insights: obtaining better terms for one's work and reaping profits from well-judged investments. I think of "flourishing" as acquiring *non-material* gains through living imaginatively, creatively and adventurously: enjoying the fascination of venturing into the unknown; the thrill of discovery; and the satisfactions of personal growth.

For most people, flourishing requires being engaged in innovative activity. The breadth and depth of prospering and flourishing in Britain will depend largely on

its own dynamism: the desire of the British people to attempt innovation, their capabilities at innovating and the latitude that society gives to innovative activity. My impression is that the UK



THE BREADTH AND DEPTH OF PROSPERING AND FLOURISHING IN BRITAIN WILL DEPEND LARGELY ON ITS OWN DYNAMISM

lost quite a lot of its dynamism between the 1930s and the 1950s. It is imperative to get it back. The world's scientists won't help much. A recovery in US innovation from the weakness that developed in the late 1960s would help, but it cannot be counted on.

You have expressed concern about the reduced dynamism of the US economy since the 1960s. What are the causes of this and how can they be addressed?

Another theme in my book is the cultural roots of the desire to innovate and the cultural roots of society's resistance to innovation.

We all know about the harm to innovating brought by rent-seeking, vested interests, social protection,

etc. etc. but ultimately these social attitudes and practices can be traced back to the struggle between modernism and corporatism.

In the 19th century modernism was on the rise and corporatism was receding, but since the middle part of the 20th century the tide has turned and now corporatist values are riding high.

I think innovation has been pretty weak on the whole in most of the West since the late 1960s and I think the cause is a resurgence of some core elements of corporatism that prohibit aspiring innovators from introducing new products and methods and that inhibit people from attempting to become innovators.

How would you compare the long-term economic outlook of Europe on the one hand with China and other more recently developed economies in Asia on the other hand?

It could go either way. Imaginably, Europe will reform itself, root and branch, and that will usher in a new epoch of indigenous innovation such as Britain started up in 1815 and Germany and France around the 1870s. To some observers it seems that Europe simply does not want to embrace dynamism.

In contrast, an increasing number of Chinese do want to acquire dynamism throughout the land. China's premier has read my book and grasped its vision of mass flourishing. He has said: "imagine how powerful it would be if 800 or 900 million Chinese workers were to be engaged in creative, innovative and entrepreneurial activity!" There have been expressions of interest in transforming Greece to a nation of dynamism. In Helsinki a movement has adopted the name "Mass Flourishing Finland". It would be great if next we see "Mass Flourishing Britain".

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