RESTORING THE VITALITY OF THE WEST

Edmund Phelps

We thought we understood our nation's economy. It was a kind of machine. We knew how to fix it when it malfunctioned and how to engineer possible improvements worth making.

We believed this economy made available abundant jobs paying rising wages. Science made discoveries, which wafted down on the economy like manna from heaven, and our economy could exploit them to make economic growth – a view young Joseph Schumpeter proposed a century ago.[1]

We came also to believe that, in this mechanical economy, people had only to work hard to share the basic rewards of participating: People earn the going wage for their kind of work and the going return on their wealth. The market mechanism determines the wage and the rate of return. A person's engagement or responsibility plays little or no part in these rewards. The rewards were believed to be societal, *not personal*.

Similarly, entrepreneurs earn the going profit from their kind of business undertaking. The market determines the reward to that kind of undertaking. An entrepreneur's insight or zeal – let alone imagination or vision – plays no part in this reward. These undertakings are just the hard work of nameless

[1] See Joseph Schumpeter, *Theorie der wirtschalftlichen Entwicklung* (Vienna, 1911) and Gustav Cassel, *The Theory of Social Economy* (Stockholm, 1918). On fundamentals, Friedrich Hayek did not disagree. See his "The Use of Knowledge in Society," American Economic Review, May 1945.

business people reacting to signals of opportunities in a market economy. The belief, then, was that the work of entrepreneurs is *not personal* either.[2]

This mechanist view of existing economies inspired the further idea that companies – large ones, at any rate – could offer workers lifetime contracts when joining a company.[3] Companies would become secure fiefdoms.

Some economists of this view were inspired to propose that public policy reorient the economy toward greater leisure, public amenities and longer life expectancy – through tighter curbs on the workweek and higher tax rates on consumer goods. [4] Some non-economists go farther, proposing a "universal basic income" – the UBI. They want the economy to be a Nirvana.[5]

The mechanist view did not mean that the private sector never needs "managing." When the economy loses speed or veers off the expected course, the believers saw the economy as "failing" society and proposed some "stimulus" to regain "demand" or key tax cuts to boost "supply." It never occurs to them that it is *society* that has failed.

But this mechanist view casts little light on rapid growth, high prosperity and wide flourishing over recent decades – the decline and the way back.

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[2] Evidence for such beliefs goes beyond the textbooks. There is the famous statement by Geraldine Ferraro in her vice-presidential acceptances speech on July 19, 1984: "The promise of our country is that … if you work hard and play by the rules you can earn your share of America's blessings."
There is also the comment by President Barak Obama on July 13, 2012 to an entrepreneur who had just started a company, "you did not make that."

[3] Costas Azariadis, "Implicit contracts and underemployment equilibria," *Journal of Political Economy*, month,1975.

[4] Joseph Stiglitz and Jean-Paul Fitoussi, *Report of the Commission on the Measurement of Economic Performance and Social Progress*, (OECD, 2009).

[5] See Philippe Van Parijs, *Basic Income* (Harvard, 2017). For an exchange, see Van Parijs, "A Basic Income for All," and Phelps, "Subsidize Wages," *Boston Review* October/November 2000,

I

The mechanist view has got wrong our history. It misunderstands how the brilliant economies from 1820 to 1970 or so – Britain and America, later Germany and France – brightened the lives of most participants while also performing prodigal feats of productivity growth. Evidence suggests that innovation was indigenous, chronic and endemic down to the grassroots – not commercial applications of the latest discoveries by the world's scientists.[6] Almost every economic advance, large and small, sprung from one or more individuals in the *economy* who conceived a better method or product and who judged it would have adequate chances of adoption to warrant developing and marketing it. They were responding not to an "opportunity" that struck them or they stumbled upon but rather to their desire to let free to think for themselves, find adventure, let free their imagination and journey into the unknown.

II

Now we see the West's economies in decline – to varying degrees. Those who subscribe to the mechanist theory, both Keynesians and Supply-Siders, struggle to explain it with their "mechanisms." But a deep unease is stirring. The large advanced economies in the West are showing two symptoms.

First, these economies have suffered since the '60s or earlier – aside from the Internet boom – *slow growth* of what economists call "total factor productivity" or tfp. (Some of the less advanced had high tfp growth longer, since they were catching up.) The slowdowns of tfp were greatest in what

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6 Edmund Phelps, *Mass Flourishing: How Grassroots Innovation Created Jobs, Challenge and Change* (Princeton, 1913).

were the *lead* economies – the US slowed in the late ‘60s, France in the ‘80s, Germany in the ‘90s and the UK (which had regained speed in the ‘80s) slowed again in the early ‘00s – where the declines in *indigenous innovation* were quite strong. Investment and wages ultimately slowed as well. This is Alvin Hansen’s “secular stagnation.”[7]

Second, in these same economies “working class” wages or jobs (or both) have disappointed expectations. In France, manufacturing employment has fallen since the ‘70s by 15 per cent of total employment. [8] In Germany, the bottom 40 percent have the same income they had 25 years ago.[9] In the U.S., average hourly compensation of production and other non-supervisory workers in the private sector grew far more slowly than that of the others. [10] And non-participation of (non-institutionalized) men ages 25 to 64 rose from around 3 per cent in 1965 to nearly 10 per cent in 2005.[11] This is what is called a “loss of inclusion.” (In contrast, the lowest paid group, those without a high school diploma – largely blacks and Hispanics – did *not* lose ground relative to the median wage income earners.)

The loss of “growth” helps to account for a *broad* discontent over recent decades with working life in America; and in Europe perhaps it helps explain what seems to be a widespread lack of interest in work among Europeans. When growth is slow because employees are not involved in

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[7] Alvin Hansen, “Capital Goods and the Restoration of Purchasing Power,” *Proceedings of the Academy of Political Science*, Vol. 16, No. 1, Money and Credit in the Recovery Program, April 1934, pp. 11-19, and his *Business Cycles and National Income*, (New York: W. W. Norton, 1951).
[8] The percentage went from 28.0 % in 1976 to 13.0% in 2013. U.S. Bureau of Labor Statistics.
[9] Marcel Fratzscher, ‘A German debate over Europe is overdue,’ Financial Times, 1 March 2017.
[10] The average compensation of production and nonsupervisory workers – about 80 percent of private payroll employment – grew from 1973 to 2014 by only 9.2%. See Economic Policy Institute. See also “The Productivity-Pay Gap,” EPI, Updated August 2016.
[11] Bureau of Labor Statistics. See Nicholas Eberstadt, Milken Institute Review, 2nd quarter 2017.

entrepreneurial pursuits and fewer still in *innovative* pursuits, work in the business sector is less engaging.

The loss of inclusion has brought discontent to those affected. The "lag" of working class *wages* behind other wages may be one source of that. Sensing they cannot meet the standards of others (or of their parents) may cause them a loss of *self-respect*. (Adam Smith wrote of the shame a person may feel when appearing in public if he or she cannot meet the prevailing standard of appearance.[12] John Rawls spoke of the shame a father may feel who cannot afford to perform his duties as a father – to take his son to a soccer match, say. [13])

However, the trouble is *more acute* in several countries: *alienation* and downright *hostility* has developed in the Rust Belts – in America's Appalachia, Britain's West Midlands, France's Lorraine region and, no doubt, smaller areas.[14] In these troubled regions, "good jobs" have been lost, mostly in manufacturing, forcing many men to take less preferred jobs in retailing and other routine services.[15] I believe this is more serious than might be thought: Economists typically treat job losses and pay cuts of workers as simply small subtractions from their lifetime income, thus their consumption and leisure.

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[12] Adam Smith, *The Wealth of Nations*, 5th Edition, (London: Methuen & Co. Ltd.), 1904, Book V, Chapter II, "Of the Sources of the General or Public Revenue of the Society," Article IV: "Consumable commodities are either necessaries or luxuries."

[13] See John Rawls, *A Theory of Justice*, Cambridge, MA: Harvard University Press, 1971.

[14] A book of general interest on Appalachia is J.D. Vance, *Hillbilly Elegy: A Memoir of a Family and Culture in Crisis* (New York, Harper, 2016.

[15] Edmund Phelps, "The Dangers in a Repeat of Historic Corporatism," Working Paper 93, Center on Capitalism and Society, January 2017. A shorter version is in Project Syndicate on 17 January 2017.

There is a sociology on one's *feelings* about one's work.[16] That literature suggests that when men lost good jobs, many of them lost the feeling of *economic independence* those jobs provided – and food stamps don't. These men also lost their feeling of *importance* to their family, their community or country.[17] This community of workers may have come to feel as the years wore on that society has showed them a lack of *respect*. In addition, these workers may also feel an *injustice* if little of the income of high earners is redistributed to the working class, especially if redistributions go to people who do not work. If this literature is right, these workers are among their country's worst-off – even though they were not born the least advantaged.

Recent work of mine has sought to go beyond the sociological to focus on the *experiential* rewards of working. Good jobs offer room for *agency* [18] – a space in which a person might do *meaningful* work. People need such work to have a chance of *prospering* (in the non-material sense) – of having the experience of "succeeding at something. People value also the experience of *flourishing* – of "becoming" or constantly "forming" in the course of a career. They also appreciate chances for self-expression through imagining and creating useful things.[19] The "good jobs" in parts of manufacturing offered men some prospect of learning, some challenges and some attendant promotions; the bottom-rung jobs in retailing services these

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[16] The literature is noted in Phelps, *Inflation Policy and Unemployment Theory* (New York, Norton, 1972), p. *xvii* .See also Phelps, *Rewarding Work* (Cambridge, Mass., Harvard, 1997.

[17] See Andrew Clerin, *Labor's Love Lost* (New York, Russell Sage, 2014).

[18] The term is used in this modern sense as early as Richard Sennett, *The Culture of the NewCapitalism* (New Haven, Yale University Press, 2006). See also Philip K. Howard, *The Future of the Individual*, Conference of the Center on Capitalism and Society, New York, November 6, 2014.

[19] For a discussion and statistical tests, see Phelps, *Mass Flourishing* (Princeton: Princeton University Press, 2013).

men are forced to take do not. In losing "good jobs," then, men were losing the *meaning* of their very *lives,* or a central part of their lives.

It is a mark of the seriousness of the problem that many working-class men, frustrated over the jobs available to them, have left the labor force.[20] In much of the West, unemployment has recovered to rather low levels, but *male labor force participation* is considerably decreased.

The two symptoms – the slow growth and the losses of good jobs – are threatening our countries: dulling *business life* and eating away at *inclusion*. Ways may be found to alleviate the problem without grasping the root causes. But we need to find the *illness* or *illnesses* causing the symptoms.

What, then, are the underlying causes?

III

Regarding the erosion of good jobs in manufacturing, some economists see the cause as a type of *innovation* leading to "automation" and reduced demand for skilled labor. Others see it as *trade*. I have run a little test: America, Britain and France I regard as "innovation nations," Germany and Holland I regard as "trading nations." Then I ask: Which countries have suffered the larger decline in the male participation rate, the innovators or the traders? I found *large* declines of male participation in the "innovation nations" while male participation in the *trading* nations went *up*![21] Raicho

[20] The rise of suicide and drug-related deaths among Americans may be another mark of the seriousness of the problem. See Anne Case and Angus Deaton, "Rising morbidity and mortality in midlife among white non-Hispanic Americans in the 21st century," *PNAS*, Vol. 112, No.29, December 8, 2015.

[21] From 1986 to 2006 (thus before the financial crisis) UK's LFPR for men shrank from 87.6% to 83.4%, France's from 78.9% to 74.9%. Holland's *rose* from 80.0% to 84.6% and Germany's *rose* from 80.9% in *1986* to 81.4% in 2006. OECD.

Bojilov, a collaborator of mine, ran another test: He found that while labor in manufacturing has shrunk, *output* as a share of gross domestic product *has not.* (Another analysis of the issue concludes the trade has had some effect.)[22]

Regarding the slow growth in Europe's most advanced economies, I attribute it to a large loss of innovation (both indigenous and imported) in *capital-intensive industries*, most of them in the consumer-goods-producing sector.[23] Regarding the loss of inclusion in recent decades, I attribute it to a new kind of innovation taking place in relatively labor-intensive parts of the manufacturing sector. But we cannot rule out the possibility that cheaper manufactures, in lowering the cost of producing consumer goods, have indirectly helped to pull up wages to a considerable degree by building up the supply of capital and thus reducing the prices of consumer goods relative to manufactures. The large economies of the West are complicated.

What then can be done?

IV

There are myriad things that ought to be done and perhaps each of these things has found some support: Address the slowdown of productivity: That will require reviving innovation in the traditional industries as well as those Silicon Valley. It will be necessary to make it easier to start new firms and to fire workers, to cut much of the hierarchy in corporations and to reduce tax burdens on startup firms; further, allow new firms to enter existing industries and compete on a level field with existing firms. To meet the loss of

[22] Douglas Campell, "What's wrong with the US economy? A theory, in one blog post," *A blog about Manufacturing, International Trade, Monetary Policy*, March 2, 2017.
[23] It is not clear that labor-augmenting innovation in the investment-good-producing sector helps.

inclusion it may be necessary to institute massive subsidies to low-wage employment – at the cost of cutting back the government in other areas. But before all such reforms to be adopted, the government must reform itself.

If I am right, these steps and other needed steps will not be undertaken – and dynamism will not be regained – as long as the West remains devoted to post-modern doctrine. That doctrine calls on the government to defend established companies from competition by outsiders in the name of "solidarity"; to burden the creation and development of new firms through labor law, aggressive labor unions and comprehensive regulation in the name of "social protection"; and to practice clientelism, even nepotism, through a colossal public sector in the name of the "social good." This doctrine, born in the 1890s, first tried in the '20s and then revived unofficially in the '60s, has driven out Modernist values that had nourished Western innovation for more than a century.

Europeans – on any wide scale at any rate – will never experience prospering, or flourishing as long as they do not embrace the values and norms that once sparked grassroots innovation. Young people will have to be reeducated in what constitutes a good life and a good economy in order that they may embrace the individualism, vitalism, and expressionism that such a life requires.*

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