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DESIGNING A CAPITALIST ECONOMY FOR FAST GROWTH AND HIGH EMPLOYMENT IN TODAY'S GLOBALIZED WORLD ECONOMY

EDMUND S. PHELPS
Columbia University

In nearly all the market economies that we think of as part of the West there are signs of the same problem – the big decline in inclusion in recent decades. This decline takes one or more forms: a widened gap between the pay rates at the low end of the labor market and median pay, a fall in labor force participation by men, and a rise of new levels in the unemployment rates among the less educated.[1] This set back is rooted in structural factors and non-monetary forces most of which cannot be expected to go away soon, if ever.

How best to regain inclusion? Unfortunately one economist's best solution is another economist's worst solution. There is a pluralism of economic theories, so for every policy recommendation, with its theoretical premises, some clever economist will be able and eager to show that the policy will be ineffective on his or her different theory. And to be frank, we differ in our

[1] *Inclusion* implies economic inclusion – that is, inclusion in the economic mainstream – and therefore broad-based employment in the market economy as distinct from domestic work and the underground. It also entails a sort of social inclusion, which necessitates that people of sound mind and body can earn self-sufficiency through full-time work (thus to support themselves decently by society's standards) and can afford at least some basics of communal life on an equal footing (paying their own way to some events and meeting their civic duties). Receiving income support from the state does not make one a contributor to society's main activity and a self-standing member of the community.

value systems, so that some tradeoffs are deemed worth paying the price by some policymakers (or voters) and viewed as inadmissible by others. Thus we don't fully agree about what works nor on what is best.

Nevertheless I will take up in this paper the strategy I hold to be the best solution. I will also discuss some strategies that I regard as non-solutions or inadequate – why I suspect that liberalization of the labor market alone will not be enough in the really high unemployment countries and why I believe that investment subsidies, like most (but not all) subsidies, would also be the wrong direction in which to go. I will argue that the solution is an unshackling of free enterprise, both as a means to attract greater inclusion and as a way to obtain greater human happiness and economic growth from business activity, together with a massive subsidy to private employment.

I. What is the Precise Nature of the Problem?

To speak of low inclusion is not just a *rephrasing* of the phenomenon of poverty (as the latter is traditionally understood at any rate). Low inclusion doesn't mean that a significant segment of the population has a very low annual income relative to median income, in other words. Job holding is crucial in its own right, independently of total income. In my little book *Rewarding Work* (1997) I spend the first chapter arguing that, for most of us, having a job is the main means to personal development, earning one's own way (and enough to gain some access to community life) is important for one's self-respect, and that working with the others in society's institutional mainstream fosters a sense of belonging to one's society. (Phelps, 1997.) You might think that these homely truths are pretty well understood in Europe and America. "Yet," as Derek Bok remarked, "we continue to talk...as if income statistics captured the phenomenon in some meaningful way." (Domestic Strategy Group, 1998.)

By its nature, therefore, the problem is *not* solved by "throwing money" in the form of *transfer payments* to those suffering from it. That was the "solution" to the traditional poverty problem advocated by Milton Friedman and James Tobin. (When I was a young economist in the 1960s it seemed like a good idea to me too.) If the nature of the problem is that some working age people's pay rates are so low that they could not support themselves through a job in the formal, or legitimate, economy, with the result that participation in the formal economy is low and unemployment in that sector is high, then transfer payments in the form of welfare entitlements only exacerbate the problem: they make jobholding even less "competitive" as a means of support. Consolidating them into a Negative Income Tax would be remote from a solution.

It is clear that the underground economy is also not a solution nor *any part* of the solution. When payroll tax rates and income tax rates were increased in the 1970s and 1980s, the *initial* response was understandably a fall of employment in the form of both a rise of unemployment and a fall of labor-force participation. The reason is that, were pay rates to drop by enough to reduce wage costs by the amount required to restore employment, pay would be reduced *relative to wealth*, which would have incentive effects raising employer costs, with added unemployment resulting, and incentive effects on labor-force participation. Absent an underground economy, though, the *long-term* response *would* have been a fully accommodating decline of wealth and pay in equal proportion to the point where employers could afford to offer the same number of jobs as before and households would supply themselves in the same number as before. But when there is an underground economy offering an escape into alternative jobs, the employment recovery process (referring here to employment in the *formal* economy) through wealth adjustment is blocked from completion by the underground option.

Thus the underground economy, like the welfare state, shrinks and damages the formal economy by weakening performance incentives on the job and weakening the incentive to participate. (In one way it is superior to *welfare*, since at least something is produced.) Far from offering a welcome *cushion* of alternative work for people who have *irrevocably* lost the possibility of employment in the formal sector, the underground economy ultimately substitutes its inferior jobs—dead-end jobs, jobs with very long hours that would previously have been passed up, jobs that are viable only because of tax evasion, and criminal activity, all work activities that were once rejected—for the relatively good jobs that could and would otherwise have been created instead in the formal economy. The personal and social effects of this development are just as stultifying and pernicious, I believe, as the effects of the widening draw upon the entitlements of the welfare state. In any case, the toleration of both the explosion in the claimants to welfare entitlements and the explosion in persons turning to work in the underground economy are factors *causing* the problem, not solutions.

It is also important to recognize, I believe, that the West's problem is not inclusion pure and simple. The problem is the task of achieving inclusion *without* shifting to a slower and therefore ultimately lower timepath of productivity – in short, reduced growth. Any country can achieve full employment if it is willing to sacrifice private enterprise and forego a more or less free market. The Soviet system achieved it through a combination of centralized wage setting and the establishment of state enterprises willing and able to endure high rates of employee shirking, absenteeism and alcoholism; but the productivity growth the Soviets could generate, though it drew them closer to Western productivity for a few decades, was ultimately too slow to allow them to keep pace with the West. Of course, the better growth rate of output and consumption generated by the private enterprise system is not its only benefit. Most people relish and learn from the constant novelty of the challenges and opportunities presented by private enterprise and they compare it favorably with the bureaucratic jobs of the public sector.[2] In any case, to insist that our goal is the improvement of productivity

[2] Several liberal economic thinkers—libertarians in American parlance—such as Friedrich Hayek, Milton Friedman and Henry Wallich argued that, whether or not private enterprise proved superior in terms of net economic benefit, it conferred the political benefit of liberating the population from dependence on the public sector for their job and their livelihood and this benefit was a bulwark against the rise of totalitarian and authoritarian government. Writing in the 1940s and 1950s, they were none too sure of the economic benefit!

performance or at worst the maintenance of recent efficiency and dynamism is a way of *constraining* the policy choice away from a mix of policy initiatives having an anti-enterprise tilt. The great feat that most Western economists hope for is the amalgamation of inclusion and private enterprise. So the inclusion objective we talk about means substantial inclusion of the working-age population *in* a predominantly private-enterprise economy.

So there is a second objective before us, which is to unshackle the Western economies from any remaining burdens and restrictions on private enterprise – from *excessive* tax rates (where they are excessive), from *cost-ineffective* regulations (where regulations are not cost-effective or simply meddlesome without any benefit at all), and from *laggard* state enterprises (where their productivity or expansion lag behind that of comparator private enterprises)—in order to unleash a radical *improvement* in productivity performance. Improved productivity performance is an *end* in itself, not just some unwelcome constraint like not being able to get along with negative land or not being permitted to move pawns backwards.)

With two objectives, ample growth and adequate inclusion, it follows from basic economic analysis that achieving them will not generally be possible with just one policy initiative, with just one policy instrument in the terminology of Jan Tinbergen. *Two* policy instruments may be required. And it may happen that, of these two instruments, one (if not both) of them will be counterproductive for achieving some target while that drawback is counterbalanced by its great effectiveness in achieving the other target. It would be misguided to search for some Holy Grail that serves to meet all the objectives.

I would add, though, that I have come to believe, as do some other economists, that the two goals are, in some respects at any rate, complementary rather than competing. The two ends, good growth and ample inclusion, are linked in at least two ways. First, as long as the formal economy—legitimate business—remains unable to enlist the vast majority of its working-age people, schemes for make-work, "work sharing" and alternative material support gain favor, thus reducing the pace of productivity growth further and jeopardizing the revival of private enterprise. Second, good productivity performance by the business sector contributes to greater inclusion as well as being an end in itself. (I have recently come to argue, contrary to what I once believed, that the deterioration in productivity performance in Europe over the past couple of decades has contributed considerably to the decline of inclusion in the formal economy.) If so, policy actions, such as measures to unshackle private enterprise, if they raise productivity growth can be expected to boost inclusion too. Yet, such a by-product is unlikely by itself to be sufficient to reach any ambitious inclusion target. A second policy tool has to be applied.

What sort of inclusion-directed policy instrument is needed in the West, besides a stronger dose of free enterprise? The OECD counsels liberal reforms of the regulatory system. Some European countries, such as Italy, have traditionally relied on stimuli to fixed investment. Let me first comment on these approaches before I bring up my own proposal.

II. Wouldn't the OECD's Liberal Reforms Restore High Employment?

Researchers on Europe's swollen unemployment rates agree it is a structural development. They lay it to a clash between the hourly labor cost needed by employers to keep up employee morale or maintain peace with the unions, which was pushed up in the 1980s, and the hourly labor cost that businesses can pay without going into the red, which went down in the 1980s. When a discrepancy is opened between the expense required and the expense they can afford, businesses have to whittle down employment until the required expense has fallen and the affordable expense has risen by enough to eliminate the discrepancy.[3]

[3] The 'Controversy' roundtable in the May 1998 issue of *Economic Journal*, which includes my own survey in collaboration with Gylfi Zoega, gives a good picture of the present consensus.

What may be called the *consensus account* speaks of up to three shocks to labor cost — wage cost plus non-wage labor cost. The most visible of them is the rise in payroll contribution and personal income tax, which has been unrelenting in Italy. The other developments pushed up the wage rates needed by the private sector to obtain employee loyalty or peace with labor unions. One, not very pronounced in the Mediterranean countries and Latin America, is the increased generosity of unemployment benefits. The other, especially striking on the Western European continent, is the enormous increase of wealth relative to the GDP: both the massive accumulation of private wealth and the expansion of social wealth — the benefits available from the welfare state. (A wealthier worker is less dependent on his employer, so firms suffer the costs of higher absenteeism, quitting etc. — or agree to pay higher wages as a deterrent.)

The consensus account also recognizes some shocks that drove down the hourly labor cost that employers can afford if they are not to go into the red. (The effect is an increase in unemployment since employers know that to pass on the burden to their workforce in reduced pay would be unlikely to solve the problem and might make it worse.) The elevation of the world real interest rate since the early 1980s, a factor which holds center stage in my book *Structural Slumps*, is emerging in one study after another to have been a strong force pushing up unemployment. Another is legislation protecting employees from dismissal, which makes hiring a new employee a dangerous commitment. Yet another is the new information technologies, an increasingly powerful force, which have greatly increased the costliness of training new employees, especially the less qualified. These shocks have made some less qualified workers legally unemployable in countries where the wage-setting process militates against a downward adjustment in the relative pay of less-skilled labor.

Times change, though. Between the mid-1970s and the mid-1980s no European country escaped the rising tide of structural unemployment. But estimates by the OECD in its July 1998 *Economic Outlook* point to diverging paths since then. Between 1986 and 1997 the rate of structural unemployment climbed further in several economies: Sweden (up 5.6), Western Germany (2.3), Switzerland (2.3), Italy (2.2), Norway (1.4), France (1.3) and Austria (1.3). Yet, over the same span, the same rate apparently fell appreciably in Ireland (down 3.6 points), the Netherlands (2.5), the U.K. (2.3), Portugal (2.0) and Denmark (0.6 since 1990). What lessons are there in this divergence?

The thesis of a new OECD study by J. Elmeskov, J. Martin and S. Scarpetta (1998) is that the successful countries used the consensus analysis to devise a package of pro-market reforms while the failing ones did not. Ireland and the Netherlands reformed job protection and cut tax rates on labor, while the U.K. did those things and reformed unemployment benefits too. The study is impressive in its scope and care. But the quantitative analysis gives only mild support for these reforms. According to the study's own estimates, these reforms had a modest effect and in each country they explain less than half of the decline of unemployment. Indeed, Portugal and Denmark made none of those reforms. Both enacted a big raise in unemployment benefits and Ireland a significant one. Furthermore, the rise in structural unemployment since 1986 in Italy, France and West Germany is not mainly the effect of the OECD factors – in Italy not at all. (Italy is calculated to have raised unemployment benefits in this period by about as much as Denmark did; but to have offset that step backwards with reforms in the machinery of wage setting.) Something is missing.

I do not desire to undermine these liberal reforms. In fact I too oppose job protection and long-term unemployment support. (Broad inclusion in the economic mainstream is central to a decent society, but people have no right to a job for life at the expense of the employer who first offers employment and no right to lifetime pay for being unemployed at the expense of taxpayers.) Nor do I reject any part of the consensus above. (I am a proud contributor to it, even if it needs more work to fit Italy as closely as we would like.) However, the incessant claim that, if only the usual free-market reforms were instituted, unemployment would shrink to a benign level is naive. The trouble is that a key force has not yet made its way into the consensus model of unemployment. To achieve a complete cure of the unemployment problem it is essential to harness that force.

Productivity growth is a potent – and salutary – influence on the unemployment rate. First, expectation of high productivity growth in the future encourages the employer to hire new employees with the confidence that the costly investment in their training and experience will be repaid quickly. Second, rising productivity growth causes paychecks to rise toward a higher level relative to private wealth – wealth falls behind; this makes workers more eager to earn and less prone to absenteeism, quitting and shirking, which serves to reduce costs, to hold down required pay, and thus to reduce structural unemployment.[4]

European experience provides ample evidence. The countries where productivity growth fell the most suffered a far larger rise of unemployment than did the countries whose productivity growth was more nearly maintained. During the "economic miracles" in West Germany, France and Italy, when productivity growth rates was setting records, their unemployment rates were at historical lows while in the U.K., Ireland and Portugal, where productivity growth was far slower, unemployment rates were ordinary. By the mid-1980s, when productivity growth in the miracle economies had slowed to the more nearly sustainable rate of the other group, their unemployment rates had rocketed up to be among the highest in Europe while in the U.K., Ireland and Portugal productivity had hardly slowed at all and unemployment rates had risen far less.

The precipitous productivity slowdown was also a factor in the further rise of unemployment, after 1986, among the OECD's failing students — Sweden, West Germany, Italy and France. Since wages had grown so fast for so long in the miracle years, wealth was still far below its new target relation to wages in 1986 and was therefore in the process of drawing nearer to wages over all or most of the period up to 1997 — and driving up the unemployment

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4 The reasoning, which builds on work of Pissarides and, later, Aghion and Howitt, is laid out in 'Growth, wealth and the natural rate' by Hoon and Phelps (1997).

rate in the process. The massive pile-up of wealth relative to pay is resulting in a society less eager to earn and less receptive to the dictates of business.

The main reason for the huge fall in productivity growth in France and West Germany in the 1970s and 1980s, and the more gradual fall to the same low pace in Italy, is that aggregate productivity hit a ceiling once production methods reached technological excellence in virtually all industries; in the U.K., Ireland and Portugal that ceiling was not hit, perhaps not even now. Yet Italy, where productivity is markedly lower than in France or West Germany, evidently has some non-technological hurdles to high productivity still to overcome.

III. Wouldn't Measures to Stimulate Fixed Investment Help?

In a great many countries the traditional policy of the government has been to seek to boost productivity and therefore employment through financial support to fixed capital investment, public and private. In fact, the history of this policy is seen in most of these countries to have been one of chronic failure, as subsidized plants and infrastructures proved to be misallocations of capital. Despite that verdict, the discredited view of capital as the wellspring of growth – or *a* wellspring at any rate – never really dies, as one generation after another looks to capital as the vehicle for job creation. (In Europe, Franco Modigliani and Jean Paul Fitoussi have suggested such an approach.[5] Gilles Saint-Paul, noting that capital is internationally mobile and labor not, argues for confining tax cuts to domestic capital and even for increasing taxes on labor in order to finance *negative* taxes on domestic capital.[6])

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[5] Franco Modigliani and Giorgio La Malfa, "Piu Lavoro? Una Strada C'E'," Corriere della Sera, January 3, 1998, and "Perils of Unemployment," Financial Times, January 16, 1998; Jean Paul Fitoussi, "Contro I Mercati Vince La Politica," La Repubblica, 30 April 1988, p. 1.

[6] Gilles Saint-Paul, "Would Shifting the Burden of Taxation from Labour to Capital Reduce Unemployment?" presented at the conference Rethinking the Welfare Society, CEPR,Vigo, 20/21 June 1997.

Of course, those readers who are advocates of the so-called free market will not need any demonstration that capital subsidies are ineffective or even perverse. Free marketeers such as Hayek detest all subsidies. My stance is more pragmatic. It is that subsidies may be countenanced and welcomed but only where there is a presumption of an extraordinary social return from the outlay. The question is therefore an empirical one.

The first weakness of the capital subsidy method of restoring employment is that there is not, generally speaking, direct evidence that additional capital invested in the public sector or by private-sector enterprises would have a strong positive effect on productivity.[7] The meager return on capital formation estimated in many countries, from Italy to Japan, may be in part the result of a banking system that finds its self-interest in continuing to make loans to tired enterprises for bad projects rather than to open up to new borrowers and start-up firms. As the banks grow more oriented toward overseas lending, their financing of bad investment at home can be expected to diminish.

It is one thing to raise productivity in the sense of output per manhour and quite another thing to raise it *net* of the interest and other capital costs entailed by the investment. Even if the increase in the gross domestic product yielded by additional investment in private or overhead capital is well above zero, a correct accounting of cost and benefit must charge to the project the cost of capital — the real interest rate in the world capital market (since the funds for the investment could have been placed in overseas assets and the interest earned could have been spent on tax credits to employers or employees) plus the depreciation rate on the investment.

The most grave objection to the continued resort to capital subsidies, however, is that they represent a reversion to socialist – or perhaps one might say socialist/corporatist – ways of running the economy when a great many Western economies badly need capitalism as the operating system. Capital subsidies are deeply inimical to the spirit of free enterprise. Investment

[7] The next couple of paragraphs draw on Phelps (1998), which contains some rough calculations of the path of the rate of return to fixed investment in Italy.

projects should spring from the independent inspirations of individual entrepreneurs pinning their hopes on the decentralized judgments of many investors and lenders about which projects are to be financed. Projects should not come from entrepreneurs aiming to guess what sort of project will be accepted by the giant regional state bank. Worse yet, some part of any capital subsidies tend to go not to private enterprises but to public agencies that will invest in infrastructure, so the commercial and entrepreneurial culture is by-passed rather than harnessed. And to the extent that money does go to subsidize the projects of private enterprises, the money seems more likely to go to those with the most politically correct project than to those with the most profitable prospects. So it tends to cultivate the art of rent-seeking rather than the practice of profit-making in the marketplace. Thus capital subsidies are peculiarly apt to distract from and delay taking up the task that is crucial for achieving high employment and development: to break away from broad dependency on the state and instead to rest the economy on self-reliance, initiative and creativity of legitimate private business.

IV. A Sketch of a Solution

What is to be done, then, to restore inclusion? An operational program is beyond the scope of this paper and beyond my capabilities now. The details ought to vary from country to country. To strengthen the capacity of a country's capitalist system to generate productivity growth it is obviously important to develop a broad capital market, with attention both to stocks and corporate bonds, to which entrepreneurs may go for finance and investors without expectation of being deceived or defrauded. A fundamental task in the less developed market economies is the work of improving corporate governance and bankruptcy provisions. In several countries, such as Italy and Japan, it is particularly important to reform the banking system so that it better meets the needs of entrepreneurs. As I noted above, the poor skills and inappropriate incentives within banking system appears to have contributed to driving down the return on capital in established firms while depriving others of loans and failing to support firms with needed financial services and risk capital.

Yet it must be recalled that these necessary reforms, which are so welcome in their own right and which may also prove beneficial to inclusion, may fall seriously short of restoring inclusion to a high level unless they are accompanied by additional steps to ensure that a decent share of the benefits reach the less advantaged. I believe that the most important measure the government can take of this kind is to award employers a subsidy (in the form of a tax credit) for their employment of low-wage workers. This would ensure that a satisfactory portion of the jobs in the private enterprise sector will be filled by low-wage workers.

It should be noted that, theoretically at least, an employment subsidy financed through an increase of the payroll tax unambiguously expands employment. It is natural that the remedy for a deficiency of employment is a subsidy to employers for employing workers, not a subsidy to them (or to their lenders) for utilizing capital.

Of course there are objections. There are so many of them, most of them with little or no merit, that it would take tens of pages to deal with the bulk of them. Besides, in my *Rewarding Work* I have given the subject a chapter a book-length treatment.

What I would like to discuss here is the question of financing. In the book, which is directed toward the problem of depressed pay and inflated unemployment among low-end workers in America, I suggested a payroll tax as the method of finance. The joint effect of an increase in the proportional payroll tax rate and a fixed employment subsidy – or one gently declining with the pay rate of the employee – is to pull up pay rates as well as employment among low-wage workers. The "downside" is that the median worker, who will presumably not be in the range to receive any subsidy money, will be a loser as a result of the increase in the payroll tax rate. The median workers' paycheck and employment will both decline over the short run, until wealth has adjusted completely – if it ever does – to the reduced pay rate trajectory.

Where the unemployment tends to be shared more evenly between high education and low education members of the labor force, however, this package may seem insufficiently suited to the unemployment problem. My question is whether, in such countries at least, there is a better way to finance employment subsidies. In fact, I believe there are three preferable ways to finance such subsidies in Europe.

One source of finance in those countries where it is available would be the huge savings from abolition or contraction of the subsidies to capital. These subsidies grew up in the 1930s, the heyday of theoretical welfare economics, when it became fashionable to second-guess the market on every decision. Today economists take a different view. There are situations in which there would be a huge social gain from a subsidy. I believe it is logically inconsistent of Hayek to argue against all subsidies, generally using the slippery-slope argument, while endorsing a wide assortment of government functions *he* apparently approved of – including even transfer payments to the poor! It seems to me that Hayek's argument ultimately reduces to no government at all, to a sort of nihilism. Today's economists are less doctrinaire than Hayek. They insist only that there be a presumption of an overwhelming social benefit in a subsidy – as measured by the beneficiaries' willingness to pay to keep the subsidy on the books if there should be a need or, if they are all on the margin of subsistence, by the willingness of advocates to pay.

Another source of finance is an increase in tax rates on wealth. In my analysis, a great deal of the huge rise of unemployment in the West, especially the rise on the European continent where there was a sharp drop in the growth rate of productivity, is attributable to the momentum behind wealth accumulation in the face of a sharp slowdown in the rate of growth of real wages. Another large part of the rise of unemployment is attributable to the sharp rise in the world real rate of interest, much of it driven by the boom in East Asia (which is now quiescent for the time being at any rate). A country could tax away some of that wealth and the extraordinary return being earned on that wealth and then funnel it back to the population through employment subsidies. In that way the government would be restoring somewhat the old balance between the reward to work and the reward to saving. And there would be the further benefit, compared to payroll-tax financing, that no one's paycheck (net of tax) would be reduced by the need to finance the subsidies. Work would be king again, and accumulated wealth would be put in its place, so to speak.

Here I would endorse in principle the heroic efforts of Mario Monti at the European Commission to institute a choice for lenders: one can relinquish anonymity when buying bonds elsewhere in Europe or one can pay a witholding tax on bearer bonds. Yet I agree with the critics who are reluctant to see Europe take this initiative unilaterally, without first lining up the United States and Japan – and even then there have to be qualms about the possibility of rogue countries that might persist in offering tax havens for bond buyers.

The third of the possible methods of finance I would like to point to is a trimming of various welfare-state entitlements. This method seems clearly attractive in welfarist Europe, where the welfare state has so seriously undermined employment in legitimate business; obviously it is a less promising source of finance in Latin America, including Argentina, where the welfare state is not so over-developed. With regard to Europe, however, my analysis, both theoretical and empirical, indicates that an appreciable part of the rise of unemployment in Europe is the tremendous increase of social wealth relative to pay from work. Europeans are rich relative to pay not only in terms of their private assets, from their country homes and the boat to their bonds, but also in terms of their social entitlements. It is pathological that politicians in Europe have been permitted with impunity – without even so much as a serious criticism! – to remove the need for self-support and individual initiative, and thus to downgrade these social values and to depreciate work itself. The very character of life is at stake here.

As I remarked, the welfare state has not yet developed in Latin America, including Argentina, to the level reached in Europe. But that does not mean it is not headed that way. Insistent pressures on the nations of East Asia are being exerted by Europe, through the IMF and the OECD, to adopt the welfare-state apparatus now in place in Europe. Latin America must resist if it wants the rebirth of a vibrant inclusive capitalism.

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