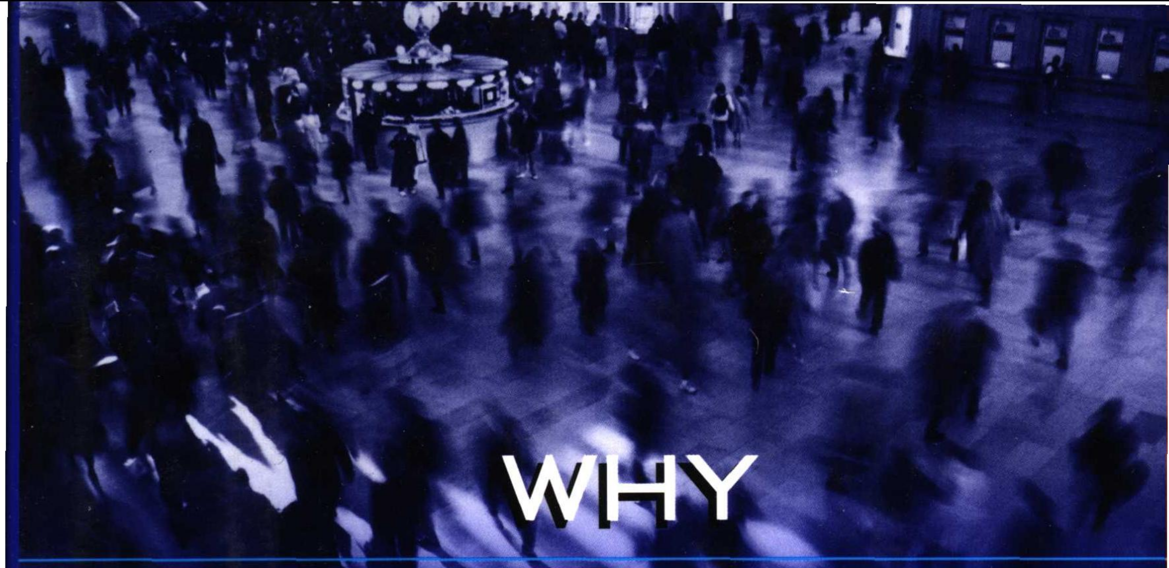

WHY ECONOMIES GROW

The Forces That Shape Prosperity and How To Get Them Working Again

A Century Foundation Bo

JEFF MADRICK

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The past two years have been an unhappy and uncertain time for the once-unstoppable U.S. economy. The dot-com bubble has burst, the major stock indexes have lost hundreds of billions of dollars of value, there is a crisis of confidence in corporate governance, and the economy as a whole is growing sluggishly if at all. These developments have many people asking questions they thought we'd already answered: What makes economies grow? How can we get ours healthy again?

There are any number of one-dimensional answers to be had. Some focus on the national savings rate. Others take for granted that growth is driven by new technologies. In his new book, *New York Times* columnist Jeff Madrick argues that these factors are not as dominant as many believe and all the emphasis they receive leads us to ignore other crucial factors. The most important of those neglected is the strength of market demand itself.

The surprising thesis at the heart of *Why Economies Grow* is that the process of growth is far more complex than most pundits, business journalists, and even economists believe. But it can be understood. Madrick re-examines the 1990s in light of earlier booms, shows why technology did not give rise to a "new economy," and tells what we need to do to restore rapid growth to the U.S. economy.

His original take on economic vitality, from the Middle Ages to the present, will surprise and inform everyone, and unsettle many. Avoiding the simplistic interpretations that now dominate economic discussion, Madrick proposes as economic agenda for the nation that is both historically well-founded and sharply different from the current one: an agenda that is led by government and that stresses the breadth and complexity of real growth.

Why Economies Grow

Also by Jeff Madrick

Unconventional Wisdom:
Alternative Perspectives on the New Economy (editor)

The End of Affluence

Taking America

The Century Foundation

The Century Foundation, formerly the Twentieth Century Fund, sponsors and supervises timely analyses of economic policy, foreign affairs, and domestic political issues. Not-for-profit and nonpartisan, it was founded in 1919 and endowed by Edward A. Filene.

Foreword

THE 1990s WERE FOR MANY THE BEST OF TIMES. AMERICAN popular culture, at least, suggested that success was rampant and helped to generate a remarkable degree of optimism. The sensational boom in technology stocks and in the broader market produced an unprecedented increase in equity values, especially in areas that seemed related to the revolution under way in computers and communications. Great fortunes were made and widely celebrated in the media. More important, a surge in productivity late in the decade seemed to fulfill some of the promise that had been long anticipated as a result of the widespread adoption of computers by businesses and individuals.

In the midst of what seemed like total enthusiasm, there were some analysts and scholars arguing for a more cautious assessment of the impact of these new technologies on the overall economy. They stressed that, although the computer revolution was undoubtedly important, it was still too early to forecast its long-term effects on growth and incomes. Still, as the valuation of the "computer stocks" skyrocketed, it was difficult not to be carried along by the pervasive exuberance. Finally, the inevitable market "corrections" at the end of the decade and during the early years of the new century forced a more sober calculation of the effects of the new communications technologies and the information revolution.

During the years before our current, more realistic view of the so-called new economy was arrived at, perhaps the greatest failure in our understanding of what was actually happening could be attributed to a routine deficiency in our knowledge of economic history. There were various reasons for this. Economics, as an academic discipline, moved during the past several decades to more intense concentration on theory and model building. Although this work often proved quite valuable, in many ways it has lessened our understanding of real world cases from both the present and the past. Economic historians generally have not picked up the slack, especially those with a primary focus on political and social developments. There are few in the field who combine a working knowledge of fundamental economic principles and a deep understanding of economic history; there are even fewer who can transform those insights into accessible and penetrating prose. The author of this volume, Jeff Madrick, is one.

This book is not the first project Madrick, who is editor of *Challenge* magazine, author of *The End of Affluence: The Causes and Consequences of America's Economic Dilemma*, and a contributing columnist for *The New York Times*, has done with The Century Foundation. He served as the editor of our collection of essays on the economic developments of the past decade: *Unconventional Wisdom: Alternative Perspectives on the New Economy*.

The strength of this book comes from Madrick's ability to see the interaction of social, legal, technological, and other cultural change with the economic growth that he is explaining. Far from the mechanical modeling of some economists (who would divide economic growth into the percentage due to capital deepening and the remainder due to technology), Madrick's analysis incorporates the complex changes that occurred during the evolution of capitalism.

As he notes, raw materials have nothing or almost nothing to do with the acceleration of growth. Raw materials, which have been around throughout human existence, have become more useful economically only because our knowledge and imaginations have developed new ways to extract and use them. Indeed, even wider exchange, migration, and growing markets—which Madrick assigns the central place as prime mover of economic growth—ultimately depend on new means of transportation, communication, and warfare, themselves the fruit of accumulated knowledge. Madrick never lets us forget that we are unimaginably rich and long-lived by historical standards only because of the gradual and organic evolution of institutions of governance and commerce, cultural developments that have enabled us to trade, urbanize, and invent.

Madrick's analysis also points up the sluggishness of income for most workers. The most recent generation of Americans experienced a sharp increase in wealth and income inequality, something that was basically unexpected and is increasingly troubling. Although some analysts have attributed this to a statistical fluke caused by not taking account of the young people who move up the income ladder in the course of their lifetimes, more careful research has indicated that this has been taken into consideration. The current consensus is that starting in the early 1970s income inequality increased. Although many had hoped that productivity gains and the widespread dissemination of computers would help alleviate inequality, evidence to that effect is lacking.

How then should we view today's economy? Madrick argues persuasively that the new economy hype of the late 1990s was just that. The fundamental driving forces and institutions of capitalist economic growth have not changed. The new inventions, cheaper communication, and better organization of knowledge that developed so rapidly in the 1990s no more repeal the laws of motion of capitalism than the invention of the internal combustion engine or the electrical motor did. To focus on major technological innovations and ignore the myriad adaptations, extensions, and financial accommodations that markets breed is to trivialize the process of economic growth and remove its fundamental continuity. Madrick's contribution, then, is to place our recent economic growth in a historical and institutional perspective. If we are not in a breathless new economy, we still have reason for confidence in the long-run robustness of capitalist economic growth.

Economic developments have been a major area of study for this organization from its founding. This book is a part of a wide range of examinations of various aspects of the American economy we have supported over the past decade, including the essay collection edited by Madrick, *Unconventional Wisdom,* mentioned previously; Robert Kuttner's *Everything for Sale*; Jamie Galbraith's *Created Unequal*; Barry Bluestone and Bennett Harrison's *Growing Prosperity*; Paul Osterman's *Securing Prosperity*; Alan Blinder and Janet Yellen's *The Fabulous Decade;* and the volume of essays we cosponsored with the Russell Sage Foundation, *The Roaring Nineties.* We also are looking at economic policy in a number of forthcoming studies: Simon Head's examination of the impact of technology on economic inequality; Jonas Pontusson's study of what the United States can learn from other nations about the workforce, economic inequality, and public policy; and Edward Wolff's analysis of skill, work, and inequality.

The final verdict on the new economy is far from clear. Both real world experience and rigorous analysis are at a preliminary stage. Still, it seems quite certain that for many years to come Madrick's work will provide a critical guide to our understanding of what we have been and where we are headed. We look forward to his continuing work in this fundamental area of public policy and American life.

Richard C. Leone, President
The Century Foundation
May 2002

Acknowledgments

WHEN A BOOK RUNS AGAINST THE CONVENTIONAL WISDOM, IT requires the support of brave people. This book was conceived when almost everyone believed that a new economy had swept the nation towards a prosperity of unprecedented proportion and unending duration. To the question, why do economies grow, the chorus answered that it was technology, of course, aided by a return to unregulated markets.

This book offers a decidedly different answer. I must first thank Richard Leone, president of the Century Foundation, for his continuing support of this at times unpopular venture. Second, I must thank his lieutenant, Greg Anrig, for similarly undiluted support. Beverly Goldberg, director of publications at the Century Foundation, was critical to its publication. The Century Foundation economist Bernard Wasow, not always in agreement, provided important suggestions for the book. Further sincere thanks go to Jason Ranker and Sarah Nelson.

Yet another round of supporters requires acknowledgement. John Donatich, publisher of Basic Books, and William Frucht, became enthusiastic and respectful supporters of this book. Their enthusiasm made me a better writer, and I very much appreciate it. As editor of the book, Bill Frucht was not only a constructive editor but also a nourishing presence. I would like to thank Felicity Tucker and her copy editing staff, as well as the jacket designer, Bradford Foltz, for their excellent work.

Finally, let me thank again, as I did in a previous book, economic historians as a group. I mildly criticize some of them in this book, but I am grateful to all of them. They should be more highly regarded in their academic profession. They provide perspective to a discipline that is more often influenced by ideology or fashion than is admitted.

All of my family and a few key friends are my best advisers. I thank them most.

Contents

1

Why Economies Grow

AT A CONFERENCE NOT LONG AGO, AN ECONOMIST PLACED ON the overhead projector a graph all too frequently used when discussing the origins of economic prosperity and growth. It showed a line that rose slowly during the Middle Ages, representing a negligible rate of economic improvement over eight centuries between the years 1000 and 1800. But around 1800, the line shot up at an angle of 45 degrees or so to the present. The Industrial Revolution had begun, and incomes consistently advanced at a rate that was extraordinary by any former historical standard.

The economist then asked the conventional question: Why wasn't technological advance adequate to raise rates of growth before 1800? He assumed, like many and perhaps most historical observers, including many trained economists, that technological advance was the origin of economic growth, and the central and implicitly even the sole cause of the Industrial Revolution. By "technological advance," he apparently meant the great inventions, from spinning wheels and water mills to steam engines and electric dynamos. In other words, there just were not enough great inventions to produce rapid economic growth in the Middle Ages and even the Renaissance until the more or less magical demarcation point around 1800.

Similarly, if asked why the U.S. economy grew so rapidly in the late 1990s, most people today, including many economists, will answer with nearly perfect certainty that it was because of new technology. In particular, of course, they mean information technology generally associated with semiconductors and computers—again, great inventions.

This book argues that such a view of growth is wrong. It tests the conventional wisdom on this and a wide range of matters, using historical, anecdotal, and empirical evidence, as well as economic theory. The central argument is that inventions in and of themselves are not the sole or even leading source of prosperity. Technological innovation is necessary to growth, but it is as much a consequence of economic opportunities as it is their cause, and perhaps even more a follower of economic growth than a leader. Moreover, technological advance does not include just great inventions but also hundreds and often thousands of related innovations. Even the great inventions were more incremental developments than is widely believed, with many contributors and innovators building on what preceded them.

This book argues that the growth of markets through trade, colonization, and domestic expansion was the predominant factor in Western economic development. By "markets" I mean groups of people exchanging goods and services. These markets grew as population and incomes grew. The growth of markets was closely associated with the rapid flow and dissemination of information, which was typically a by-product of expanding markets and immigration. Markets and information are inseparable. Such a view implies that the policies most popular today to support economic growth, including increased savings, deregulation, and other laissez-faire approaches, and even subsidies to research and development, are inadequate. Markets and information, even if the predominant causes of growth, are not sufficient factors for growth. In fact, many factors cause and enhance economic growth, and in turn affect each other. To take a contemporary example, many countries had access to America's market in the decades after World War II, but among developing nations only East Asians were able to take full advantage of it. Aside from the size and growth of markets, the flow of information, and technological advance, these conditions of growth also include the literacy, educational attainment, and health of the population; the distribution of wealth or income-making assets; the availability of financial capital; the development of financial and legal institutions; the abundance of natural resources; the vitality of entrepreneurialism; and peace and political stability. Most of these are necessary conditions for growth, but no one of them is sufficient in itself. All are both cause and consequence.

Still, over the course of modern economic development, which this book takes as starting around the year 1000, some of these factors have been more important than others. To put it differently, some are closer to first movers than others, closer to a true source of prosperity.

If we were to place them on a continuum, with those factors that are more cause than consequence on the left, market size and dissemination of information are furthest left and are closest to first movers or true leaders. In addition, the first of these is the size and expansion of markets for goods and services. The possibility of trading goods in large volume was a major source of growth beginning at least in the Middle Ages. Domestic markets, including internal trade, as well as cross-border trade, provided the possibility to produce goods on a large and efficient scale, creating powerful demand for services, notably communications, transportation, and the retailing and wholesaling services associated with the exchange of goods, and providing incentives to create new products and new techniques. Exchange and trade always entailed a flow of new ideas and information.

The existence of markets in itself implied that private property was acceptable or protected, even if only by the force of owners or traders. But legal institutions, or semilegal ones, including judicial systems, were more the consequence of growing markets and trade than their cause. The early existence of markets does not mean that