the RISE and DECLINE of NATIONS

Economic Growth, Stagflation, and Social Rigidities

Mancur Olson

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Preface

It may seem strange, at a time when so many find fault with economics, that an economist should claim to extend existing economic theory in a way that not only explains the "stagflation" and declining growth rates that have given rise to the recent complaints, but also provides a partial explanation of a variety of problems usually reserved for other fields—the "ungovernability" of some modern societies, the British class structure and the Indian caste system, the exceptionally unequal distribution of power and income in many developing countries, and even the rise of Western Europe from relative backwardness in the early Middle Ages to dominance of the whole world by the late nineteenth century. Yet the successful extension or improvement of something we have found unsatisfactory is commonplace: the technology that was impractical or full of bugs may after further development become economical and reliable. So also economics, even when it has encountered increasing skepticism, may with the aid of a new idea help to explain matters it could not explain before.

If we step back to gain perspective, we see not only the embarrassments of many economists in the last decade, but also more than two centuries of cumulative intellectual advance. I am fond of quoting Newton's assertion that, if he had seen farther than others, it was because he stood on the shoulders of giants. If Newton could say that in the seventeenth century, surely the trained economist today, however limited in stature, can claim at least as high a perch. The economist is the heir of several thinkers of recognized genius, such as Smith, Ricardo, Mill, Marx, Walras, Wicksell, Marshall, and Keynes, as well as of the yeoman labor of many hundreds of intelligent men and women. Indeed, since the giants of economics usually stood in turn on the shoulders of their predecessors, it is as though the economist today were standing atop a great pyramid of talent. Why, then, have so many economists failed to anticipate the emergence of new economic realities in the 1970s and 1980s? Perhaps it is because, wearing professional blinders, they have looked only straight ahead at phenomena economists have habitually examined. This book attempts to show that if we take the trouble to look to the side, at the domains of other disciplines, we shall gain a different conception of the entire landscape.

In part because this study encompasses several disciplinary domains, and even more because it aspires to reach policy-makers and students, I have worked hard to write this book in a language different from the one I use for articles in technical economic journals. This book is accordingly longer than it would need to be for the fellow economists who are my first concern, but I believe it is (with the exception of some notes and parenthetical expressions) also accessible to intelligent men and women in any profession. Luckily, most of the ideas I have come upon here turn out, once they are properly understood and explained, to be astonishingly simple.

I am indebted not only to the economists of the past, but also to an unusually large number of generous critics who have commented on drafts of this book and the papers out of which it has grown. These kind critics are so numerous and scattered that I have added a special acknowledgments section at the end of the book in an effort to do justice to them. The foundations and other organizations that have supported my research are less numerous, so I can mention them here. The most important source of support for my research has been the economics, social science, and policy research programs of the National Science Foundation—the Innovation Processes Research Program, the Economics Program, and the Measurement Methods and Data Resources Program. Despite their slender means and the manifold demands upon them, these programs have provided invaluable support for the research that underlies this and my other professional writings. I am also grateful to Resources for the Future, not only for support and stimulating hospitality, but also for patiently agreeing to wait when I delayed a book on their concerns to finish this book. The Environmental Protection Agency and the Sloan Foundation have also been helpful, and the Lehrman Institute, the Hoover Institution of Stanford University, and the Woodrow Wilson International Center for Scholars have also put me in their

debt with fellowships that provided some months of freedom for my writing.

My thanks to the foregoing institutions are surpassed only by my gratitude to my family. A book such as this requires intense concentration over many years, and my wife and children have, above all else, given me the peace of mind that made such concentration possible. Since *The Logic of Collective Action* was dedicated to my wife, Alison, it is fitting that this book, a descendant of that one, is dedicated to our three children.

Contents

The Questions, and the Standards a Satisfactory Answer Must Meet

1

Many have been puzzled by the mysterious decline or collapse of great empires or civilizations and by the remarkable rise to wealth, power, or cultural achievement of previously peripheral or obscure peoples. The collapse of the Roman Empire in the West and its defeat by scattered tribes that would otherwise have been of no account is only one of many puzzling examples. On repeated occasions the imposing empires of China have decayed to the point where they could fall prey to far less numerous or sophisticated peoples like the Mongols or to uprisings by poor peasants in remote provinces. The Middle East provides several examples of such collapsed empires, and so do the Indian civilizations of MesoAmerica; even before the Aztec empire was destroyed by a small contingent of Spaniards there had been a succession of empires or cultures, each of which seems to have been supplanted by a previously obscure tribe, its grand pyramids or cities abandoned to the wilderness. The pattern was not greatly different in the Andes, or at Angkor Wat, or in still other places. It was evident among the Greek city-states at the time of Herodotus, who said that "the cities that were formerly great, have most of them become insignificant; and such as are at present powerful, were weak in olden time. I shall therefore discourse equally of both, convinced that human happiness never continues long in one stay."[1]

There are many examples of insignificant tribes and peripheral peoples rising to greatness. It was not in the awesome Egyptian empire that the Mediterranean achievement attained its fullest expression, but among the previously inconsequential peoples of the Ionian Peninsula. The empires of the great city-states of Greece were of course eventually supplanted by the Romans, who before their amazing conquests had been a people of little note. The civilization of Western Christendom that had by the end of the nineteenth century come to dominate the entire world sprang from the backward and chaotic societies of Western Europe in the Middle Ages, which were usually unable even to defend themselves against the advances of the Moslems, the Magyars, and the Vikings. The parts of Western Europe that paced the advance of the West were often areas that had previously been peripheral or unimpressive; the center of growth in the seventeenth century was in the northern provinces of the Netherlands, which had never been important or wealthy before and had only lately escaped subjugation by Spain. In the eighteenth and early nineteenth centuries it was England, rather than the far larger and more imposing France, that gave us the Industrial Revolution. In the second half of the nineteenth century it was long-quiescent Germany and distant ex-colonies in North America, rather than the British Empire at its apogee, that carried that revolution farthest.

There will be no attempt here to account for the rise and fall of the ancient empires or civilizations in the manner of universalist historians like Spengler or Toynbee. If their disappointing experience is any guide, it is perhaps not even very fruitful to identify allegedly common patterns in the rise and decline of ancient civilizations or jurisdictions for which we have only scanty records. There will accordingly be no attempt here to draw universal inductive lessons from the historical experience of ancient societies.

By contrast, the suggestion here is that the hurried historical references indicate how little is understood of the rise and fall of nations and peoples. If the causes of the collapse of various ancient empires had been straightforwardly explained, the way we explain the conquest of a small and weak country in terms of an attack by a larger and stronger one, there would be no "mysterious" decay to attract continued speculation. Broad historical pageants of the kind painted by universal historians are, then, a better source of motivation for further inquiry than for immediate conclusions. But if other evidence, such as recent experience on which there is unprecedented quantitative evidence, or presumptions from oft-confirmed theory, should resonate with the familiar historical tales of the rise and decline of civilizations, then there would be a case for examining the universal histories in a systematic way, with precise questions and orderly procedures for weighing evidence. It is upon the other evidence that I shall rely here and it is to this that we now turn.

II

The economic history of the last century, and especially of the years since World War II, has its own examples of rise and decline. They are not so melodramatic as some accounts of ancient civilizations, but they are no less mysterious, and the rises and declines are probably more rapid. At the end of the Second World War the economies of Germany and Japan were devastated and observers of diverse persuasions and national origins wondered whether these abjectly defeated societies would be able to provide themselves with even the rudiments of survival. As everyone knows, the economies of West Germany and Japan have enjoyed "economic miracles" and are now among the most prosperous in the world. The German and Japanese economies not only grew substantially when these countries were rebuilding their factories and recovering to their prewar level of income, but also (and even more rapidly) after they had recovered and exceeded their previous levels of income. The problem of what we awkwardly but meaningfully call *stagflation,* or inflation combined with unusual levels of unemployment, has on the whole also been less serious in Germany and Japan than in most developed economies.

The last century also offers remarkable evidence of relative decline. The most notable case is that of Great Britain. Since World War II it has had one of the slowest growth rates of the developed democracies. Its growth rate has indeed lagged behind that of most developed countries since the last two decades of the nineteenth century. By now the per capita income in Great Britain is decidedly lower than in most of Western Europe. In the past decade, at least, Britain has also suffered relatively greater increases in both inflation and unemployment than comparable countries like Germany and Japan. The slow growth and other difficulties of the British economy have driven many people in Britain as well as in other countries to speak of the "British disease."

Within the United States there are dramatic examples of decline and at the same time notable instances of growth. The states of the Northeast and the older Middle West, and especially the great cities in these regions, have declined substantially in relation to the rest of the nation and the world. The near bankruptcies of New York and Cleveland are only extreme manifestations of a general loss in relative per capita income and outmigration in the industrial states of the Northeast and the Middle West. Most states in the West and the South, by contrast, have grown rapidly in the last few decades. These reversals of fortune have not been satisfactorily explained.

It might be thought that the examples of growth and decline that have been mentioned have been explained in the literature on the "sources" of economic growth. This literature is certainly impressive; Edward Denison's estimates of the relative contributions to growth of capital accumulation, of technical advance, and so on, have been altogether constructive, while Dale Jorgenson and many other economists have made herculean efforts to provide ever more sophisticated estimates. Yet estimates of the sources of growth, however meticulous, subtle, and useful, do not tell us about the ultimate causes of growth. They do not tell us what incentives made the saving and investment occur, or what explained the innovations, or why there was more innovation and capital accumulation in one society or period than in another. They do not trace the sources of growth to their fundamental causes; they trace the water in the river to the streams and lakes from which it comes, but they do not explain the rain. Neither do they explain the silting up of the channels of economic progress—that is, what I shall call here the "retardants" of growth.

The literature on the sources of growth helps to delineate another example of puzzlingly rapid growth. We know from this literature that capital accumulation, though considerably less important than the "advance of knowledge," is still a major source of economic growth. Since new technologies are often embodied in new capital equipment, some of the "residual" increase in productivity usually attributed to the advance of knowledge would not have occurred without investment in physical capital. Any uncertainty about economic policy, and especially political or military instability so great that it creates skepticism about whether any investment in durable capital goods will be protected, will tend to reduce productive investment. Of course, businessmen have a political incentive to exaggerate their need for stable and predictable public policies, but there can be no doubt that their insecurities can have some effect on both the level and the type of investment in new capital goods. Virtually all economists agree that events, or even expectations, that discourage investment or destroy productive capital will lower the level of income. Thus societies that are politically unstable or often subjected to foreign invasion are likely to have less productive investment and lower rates of growth than they would otherwise have had. There will be more flights of capital and fewer investments in plant or equipment that can pay off only in the long run. Savings are more likely to be hoarded in easily portable but socially unproductive assets such as gold.

In view of this, the rapid growth of the French economy in the postwar years is remarkable. It is not only that France was defeated and occupied in World War II: in less than two centuries that country has experienced some of the most profound and protracted revolutions in human history, has gone through constitutions almost as though they were periodical literature, and has suffered partial or total occupation four times. Even in the postwar period near-revolutions and fears of popular front government brought some capital flight. Given this extraordinary succession of political upheavals and foreign incursions, why did France in 1970 (the year for which we have the best adjustments for national differences in cost of living and thus the best real income comparisons)[2] have a per capita income decidedly above that of Great Britain, about the same as that of Germany, and only a fourth lower than the United States?

III

France and West Germany, with Italy and the three Benelux countries, founded the Common Market in 1957. It is remarkable how rapidly all six initial members of the European Economic Community have grown. A glance at table 1.1 reveals that in general they have grown more rapidly than Australia, New Zealand, the United Kingdom, and the United States, all of which had been spared the invasion and upheaval that "the Six" suffered. In some of these initial Common Market countries growth was more rapid in the 1960s, when the Common Market took effect, than in the 1950s, even though by then recovery from the war had been completed and they had already caught up with some of the more secure societies. One of the questions this book will attempt to answer is why the Six enjoyed such rapid growth.

In the nineteenth century there were also remarkable examples of economic growth and national advance that have never been satisfactorily explained. In little more than a century, between the adoption of the Constitution and the outbreak of World War I, the United States became the world's largest economy with the highest per capita income. In the first part of the nineteenth century the German-speaking areas that were destined to become a united Germany were relatively poor, but after the creation of the Zollverein and the German Reich Germany

Table 1.1. Average Annual Rates of Growth of Per Capita Gross Domestic Product at Constant Prices (in percent)

Country	*1950–1960*	*1960–1970*	*1970–1978*
Australia	2.0[a]	3.7[b]	2.4[c]
Austria	5.7	3.9	3.8
Belgium	2.0[d]	4.1	3.1
Canada	1.2	3.7	3.1
Denmark	2.5	3.9	2.2
Finland	3.3	4.2	2.5
France	3.5	4.6	3.0
Germany, Fed. Rep. of	6.6	3.5	2.4
Ireland	1.8	3.8	2.3[e]
Italy	4.9[f]	4.6	2.1[g]
Japan	6.8[h]	9.4	3.8
Netherlands	3.3	4.1	2.3
New Zealand	1.7[i]	2.2[j]	—[k]
Norway	2.7	4.0	3.9
Sweden	2.9	3.6	1.2
Switzerland	2.9	2.8	−0.1
United Kingdom	2.3	2.3	2.0
United States	1.2	3.0	2.0

NOTE: Data are from *Yearbook(s) of National Account Statistics* for 1969 and 1978, Statistical Office of the United Nations, New York, published in 1970 and 1979, respectively.
a. 1952–1960; b. 1963–1970; c. 1970–1976; d. 1953–1960;
e. 1970–1977; f. 1951–1960; g. 1970–1977; h. 1952–1960;
i. 1954–1960; j. 1960–1968; k. The statistics for New Zealand in this period are not separated from those for "Oceania."

grew so rapidly that by 1914 it was overtaking Britain. In the mid-nineteenth century the Japanese were desperately poor and could be almost effortlessly humiliated by the warships of Western countries, but within little more than a half-century after the Meiji Restoration in 1867–68, Japan had become the only industrialized country outside the West and one of the world's significant powers. Another of my questions is, Why did these three countries figure so prominently in nineteenth-century economic growth?

There was a commercial revolution and considerable aggregate (if not per capita) growth in parts of Western Europe in the sixteenth and seventeenth centuries, followed by the Industrial Revolution that began in Britain in the second half of the eighteenth century. Some of this growth occurred in the northern provinces of the Netherlands just after they succeeded in gaining their independence from Spain. Much of it occurred in Britain and (to a lesser extent) in France after centralizing monarchs seized effective power from the baronies, manors, and towns that had enjoyed considerable autonomy in medieval times, and then began to eliminate local tolls and restrictions that stood in the way of nationwide markets. In the aggregate these episodes of economic growth transformed the Western Europe that had been relatively primitive in the "dark ages" into a civilization that by the nineteenth century dominated almost the entire world.

The rise of the West no doubt was due to a number of different factors, many of which are explained in the history textbooks, and it would be foolish to seek any monocausal explanation. The standard accounts do not, however, provide anything resembling a complete or compelling explanation for the rise of the West, much less of the specific advances of Holland, Britain, and France during the commercial revolution or of Britain during the Industrial Revolution. Something important must have been left out. Accordingly, one of my questions is, What has been left out or overlooked in the conventional accounts? Or more precisely, What has been left out that is so crucial that we cannot get a convincing and satisying account without it?

IV

There are several further questions that may seem unrelated to the foregoing questions about anomalous examples of economic growth or decline, but these further questions turn out to be answered by the same logic that explains the notable instances of growth and decline. The first of these questions is, Why does involuntary unemployment occur, and sometimes (as in the Great Depression of the 1930s) strike a large proportion of the work force? Those who are not economists naturally may suppose that this question had been adequately answered long ago; most leading economists today agree that it has not been. In the 1930s John Maynard Keynes offered a dazzling and influential account of unemployment and depression, but now leading Keynesian and anti-Keynesian economists agree that Keynes's contribution, however brilliant and important it might be, assumes certain types of behavior that are not reasonable or fully consistent with the interests of those individuals or firms that are assumed to engage in it. In other words, Keynesian *macro*economic theory (a theory of the economy in the aggregate) does not have an adequate basis in *micro*economic theory (a theory of the behavior of individual decision-makers in the particular markets or contexts in which each operates). The non-Keynesian theories of the "monetarist" and "rational-expectations equilibrium" economists do assume rational individual behavior, but these theories do not explain involuntary unemployment—indeed, one of the reasons many economists do not accept these theories is that they implausibly imply that all unemployment is voluntary. This book shows for the first time how involuntary unemployment, and also deep depressions, can occur even when each decision-maker in the economy acts in accordance with his or her best interests. As soon as we understand how involuntary unemployment can result from rational and well-informed individual behavior, it also becomes obvious how inflation and unemployment—which we once thought could not occur simultaneously—can be combined, as they have been in the recent stagflation.

At about the same time that the ugly word *stagflation* was introduced among economists, many political scientists began to describe certain modern societies as "ungovernable." The term *ungovernability* was used by various writers in Great Britain when the Heath government fell as it attempted to assert the authority of the government at the time of a miners' strike. The term was used in the United States to describe the politics that led to the virtual bankruptcy of New York City. It has also been invoked by observers of the failures of several administrations to obtain the legislation or authority to implement most of their programs, even when, as in the Carter administration, the president's party had a large majority in both houses of Congress. The concern about ungovernability in the United States often takes the form of complaints about "single-issue" politics and the limited influence and discipline of American political parties. Thus our next question is, Why are some modern societies to some degree ungovernable? That is, Why has it seemed that governments in some countries did not govern or control their societies as well as they had in the past?

There are also a couple of questions that it will not be possible to state even roughly until much of our analysis is complete, so I will make only an oblique reference to them here. One concerns what I have chosen to call the "top-heavy" societies, because of the unusual influence of the top firms and families in the largest cities. Such societies are most likely to arise where there is political instability and an underdeveloped economy, and lead to a great degree of inequality in the distribution of income.

The last major question is a bit different. It also requires the use of a controversy-laden and ill-defined concept, so this question cannot be stated as precisely as might be wished without tedious length. In a casual sense, though, the question is straightforward: What makes the class structure more rigid or exclusive in one country or period than in another? There may be some ambiguity partly because the word *class* is sometimes used to refer simply to differences in income or status, almost as a synonym for income brackets or educational levels; but here the concern will be with any exclusivity and barriers to entry in a social structure that at least to some degree limit opportunities and countervail meritocratic tendencies. The word *class* is used in approximately this sense fairly often in Great Britain, and the model offered in this book has striking implications about one important aspect of the evolution of class structure in that country. Those who believe that class rigidities in the sense described could not occur, or would never have much quantitative significance, will change their view the moment they think of the Indian caste system, an extreme form of class rigidity, which has limited untold millions of people to particular occupations. The same theory that generates testable answers to our other questions also happens, quite by accident, to generate an explanation of the Indian caste system as well as of class or group barriers.

V

Answers of sorts have been offered to many of the questions I have posed, and sometimes these answers are even established in the folklore. This is particularly true for the anomalous growth rates since World War II. The remarkably rapid economic growth in postwar Japan and West Germany, for example, is often ascribed to the wartime destruction of plant and equipment, which induced these countries to rebuild with the latest technology. It is similarly attributed to the exceptional industriousness of their peoples, while in the same spirit the slow growth of Great Britain is ascribed to the allegedly exceptional British taste for leisure.

Perhaps because Britain has had an anomalous growth rate for a longer time, its economic performance has been the object of an unusual number of such ad hoc explanations. Britain's slow growth is often laid to the strength or narrow-mindedness of British unions, to the resistance to change or the uncooperativeness of British workers, or to socialistic economic policies. Others emphasize a lack of entrepreneurial drive and willingness to innovate on the part of British managers; establishmentarian, anticommercial attitudes that keep the ablest and best-educated people away from business pursuits; and an addiction among the British ruling classes for Concorde-type purchases of national prestige. A common denominator of most of these explanations is that they emphasize some allegedly distinctive trait of one social class or another or the rigidities in the British class system.

The above folk wisdom is not set out as a straw man easily knocked down. On the contrary, I will argue that some of the folk wisdom is partly true, and I will endeavor to provide an intellectual foundation for some of the popular suppositions. The point is rather to make it clear that the foregoing arguments, like many others, are only ad hoc explanations, and ad hoc explanations cannot be sufficient.

One reason that ad hoc arguments are insufficient is that they are usually not testable against a broad enough array of data or experience to enable us to tell whether they are correct. Each country, region, historical period, and indeed each human being is unique in many ways. Thus the fact that a country with an unusually high growth rate has this or that distinctive trait provides no justification for the inference that there is a causal connection. Only the British have Big Ben and only the Germans eat a lot of sauerkraut, but it would of course be absurd to suggest that one is responsible for the slow British growth and the other for the fast German growth. No causal explanation can claim any more credence than the Big Ben/sauerkraut argument unless it identifies an attribute that explains a number of cases or phenomena or is logically derived from a theory that has wide explanatory power. Often explanations based on a unique attribute of a country provide in statistical terms a sample of the size of one; they are equivalent to concluding, from a single toss of a pair of dice that resulted in two ones, that tossing a pair of dice will always result in "snake eyes." In some other cases where a unique attribute of a country is considered, this analogy is unfair; the unique trait may be present in different parts of the country in different degrees, or there may be enough variability or richness of other kinds to