Dynamism, Inclusion and Economic Policy

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My thesis in recent years is that a just society requires a good economy and a good economy requires high dynamism and wide inclusion. If my discussion of these ideas is to be at all intelligible I had better discuss what I mean by dynamism.

ECONOMIC DYNAMISM

I have been working on *economic dynamism* for about a dozen years, beginning with my research on Italy's economy in the late 1990s. By that term I have meant *innovativeness* in *commercially viable* directions.[†] It is important to note that episodes of rapid growth in a country or in the whole global economy can come purely from market opportunities of an exhaustible kind, such as Europe's opportunities to "catch up" in the postwar decades; so dynamism and growth are *not the same thing* and the growth rate is *not a measure* of dynamism. What, then, *are* the indications of dynamism?

Dynamism – or the lack of it – tends to manifest itself in a variety of ways. Higher dynamism in an economy tends to delivers higher productivity growth all or most of the time, thus a consistently higher *level* of productivity. Dynamism creates a distinctive sector for economic activity: employment in the financing, development and marketing of new commercial products for launch into the marketplace; and a cadre of managers deciding what to produce and how to produce it. These added avenues for employment, it may be argued, generate higher levels of total labor force and total employment. There is also evidence that

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[†] My use of "dynamism" began in my reports for Italy's science foundation in the late 1990s, later published in Phelps, *Dynamism and Inclusion in the Italian Economy*, Springer Verlag, 2002. The same concept and term are at the center of the fine book by Virginia Postrel, *The Future and its Enemies*, New York, 2003.

higher dynamism results in workers reporting higher "job satisfaction" and "employee engagement." Finally, higher dynamism also tends to produce a relatively high rate of turnover among the firms in the highest ranks (by size or market value), as one firm after another is driven out by firms that did not exist a few decades earlier.

I have been testing in the past few years the hypothesis that dynamism is so important and the disparities in dynamism across countries are so pronounced that where a country ranks in the "league standings" with respect to productivity level, employment, job satisfaction, and turnover among the big firms is largely determined by the relative dynamism possessed by its economy – its economic institutions and economic attitudes. This hypothesis has been implicit or explicit in the writings of Friedrich Hayek, Alfred Chandler, Richard Nelson, and Amar Bhide, to name a small but important subset of contributors.

Much of the general public, though – in the United States and elsewhere – are under the belief that high productivity and job satisfaction (there is some debate about job creation) are driven by the great technological advances of scientists and explorers. That view underlies the model of innovation in the 1911 book by Joseph Schumpeter, *Theory of Economic Development*. The Schumpeterian entrepreneur does not conceive anything new; this slightly tragicomic figure merely appraises the as-yet unexploited opportunities for new commercial developments made possible by the previous discoveries of scientists and explorers – and the bankers astutely size up which entrepreneurial projects are worth backing. In this world there is no genuine dynamism. According to this theory, productivity growth and lots of jobs would gradually vanish if "men in white coats" were to stop making scientific advances. Economic historians early in the 20th century, dating back to the historical studies by August Spiethoff, taught that innovation comes in great waves and that each wave can be linked to the inspired intervention of some *deus ex machina* outside the economic system – a Christopher Columbus or a James Watt or an Edison. (Later in the century Bell Labs and Tim Berners-Lee are cited.)

Yet the historical record since the mid-19th century is consistent with the existence of dynamism and consistent also with marked differences in the level of dynamism from country to country. If the German school of Spiethoff and Schumpeter were right we would see great waves in productivity growth; very similar levels of productivity and employment; and no striking differences in job satisfaction and turnover among the big firms. But we do not observe those patterns. In Canada and the United States, there is an almost unbroken record of relatively high employment, high productivity and rapid turnover. Productivity in these countries is particularly remarkable for its sustained growth: it did not slow even during the Great Depression of the 1930s, though it was awfully slow between 1975 and 1990. In France, Italy and Sweden we see (relative to other countries in the G10) a strong rise of relative productivity, employment and turnover among the largest firms from the late 19th century till World War I followed by signs of a loss of dynamism over the Interwar years – the 1920s and 1930s – that is still evident to this day. Turnover among the largest firms has been strikingly low in France and Italy; and in Sweden there have been no new members among the 20 largest firms since 1921. Japan and South Korea both have their own stories to tell..

Some elements in the general public believe in dynamism; but they say that dynamism – indeed, a more powerful dynamism than anything we have seen in North America – can best be produced by a top-down system of "industrial policy" under the direction of the state. In the 1920s, notably in Italy, it came to be believed that most of the private entrepreneurs were really no good at making economic advances so that if there were to be big innovations they would require the state to play a role. Italy's Consiglio Nazionale delle Ricerche was instituted in the Interwar years in the hope that it would supply the big, professionally run firms with new technical developments that would make possible new commercial developments. Most American economists, such as Richard Nelson and Amar Bhide at Columbia, are united in their withering rejection of this "techno-fetishism" – the notion that continued economic growth rests on organization by the state of an apparatus for generating innovations. Certainly the historical evidence of the past century runs against the thesis that initiative from the state is better than that from the marketplace. Although Lenin managed in some two decades to spread electricity across Russia, with resulting rise in relative productivity, Russia's communist economy proved unable to generate much commercial innovation; and from the 1960s through the 1980s relative productivity lost ground to rival economies. The corporatist economies of Mussolini's Italy and Hitler's Germany could not keep up with Henry Ford, Dupont, Louis B. Mayer and the rest.

My impression is that much of the hope that the government has within its hands the power to identify commercially welcome and viable innovations is not so much a vote of confidence in the state as it is a failure to grasp how dynamism – that is, a penchant for innovating in viable directions – could occur without the active role of the state. (However, this lack of confidence is strange after a century and a half of evidence to the contrary.)

So, how can we understand the generation of dynamism in a world without constant scientific discovery and without enlightened leadership of the state? What is the theory? The existing theory, started by Hayek in the 1930s, argues that dynamism is generated by an intricate system for the introduction and adoption of new products and methods: conceivers of new commercial ideas drawing on their diverse experience and insights, a diverse assortment of entrepreneurs each well matched to their projects, a diversity of views among canny financiers who select which entrepreneurs to back and to support through the development stages, and managers/consumers with the vibrancy to embrace new methods and products. The essential stuff of an economy of high dynamism is not bricks and film and electrons but, rather, commercial ideas.

It hardly needs to be said at this point that capitalism – notwithstanding its notable imperfections and malfunctions – has been the premiere economic system for the generation of dynamism. Capitalism is all about innovation in commercial ideas – their birth, development and, finally, their adoption in the marketplace**.** When an economic system of key freedoms protected by the rule of law is open for business, some participants will step forward with entrepreneurial proposals; others will amid vast uncertainty step into roles as lenders or investors to finance some of these projects; and managers of enterprises will bravely evaluate and sometimes make pioneering adoptions of the new products and methods in spite of the uncertainties**.** The willingness of entrepreneurs to innovate and invest – and thus create new jobs – is driven by their "animal spirits" as they decide whether to leap into the void.

THE GOOD ECONOMY

Of course, dynamism brings with it much uncertainty and complexity; and this concern has led to some opposition to economies of dynamism. The great theorist at the University of Chicago, Frank Knight, when pondering the arrival of capitalism, took the unprecedented position in his 1921 classic *Risk, Uncertainty and Profit* that virtually all business decisions in capitalism other than the few routine ones are to an appreciable extent a step into the unknown. The possible outcomes might have probabilities but those probabilities are unknown, thus "unmeasurable" in his terminology. This radical sort of uncertainty has come to be called "Knightian uncertainty" to distinguish it from the "risks" generated by stochastic processes with known parameters and probabilities.

Numerous observers, myself included, have described how uncertainty and complexity manifests itself, and the kinds of challenges it presents in setting monetary policy, studying the global financial system, investing, or managing financial institutions and corporations. There are hazards in acting without allowance for a limited understanding. (It is unfortunate that the style of both academic research and business decision-making has been to pretend that the economy and the financial markets are well understood. Monetary policy blunders, regulatory mistakes, astonishing financial losses, and worldwide systemic financial crises are all indications of imperfect understanding. I would mention in passing the recent book by Roman Frydman that points the way – or a way, at any rate – toward a better understanding of some markets, in particular, some asset markets.)

(A new book by Leo Tilman emphasizes that thinking in the financial industry has been rooted in models of routine situations. This has reminded me of my allusion in my Nobel Prize lecture to the "traditional economy" – an economy of routine. Such an economy might have been adequately described by neoclassical theory of economic equilibrium, I argued. However, the neoclassical theory (and its recent extensions to stochastic steady states) is hardly applicable to the modern economy, which is marked by endogenous unexpected change for which there is no prior information or model to guide decision makers. The modern economy opens the door for individuals to engage in novel activity – most importantly, the financing, developing and marketing of new products and methods. This is the very essence of an economy in which actors are free to exercise their creativity by venturing to do something innovative.)

The other objection to dynamism is that it brings inequalities in wealth that have no immediate or obvious defense. They seem morally arbitrary.

What kind of reply can be made to that objection? Is the choice between dynamism and inequalities just a matter of taste or does it depend on more fundamental considerations.

I have been arguing in the past couple of years that there is a defensible conception of the good economy – a conception that derives from the Western canon stretching back to ancient Greece. And the good economy, so conceived, requires economic dynamism *and* what I like to call "economic inclusion."

There is a humanist tradition that begins with Aristotle, who maintained that the good life was a life devoted to the acquisition of knowledge – not that everyone could afford such a life. Aristotle was followed by a school of humanists who might be called pragmatists. Virgil, a poet of ancient Rome, celebrated the human capital acquired by the Roman farmer. Later there was Voltaire, and in the 20^{th} century John Dewey and John Rawls and Amartya Sen….

And then there has been the school of the vitalists, beginning perhaps with Benvenuto Cellini in Renaissance times and Cervantes in the Baroque era.

This leads naturally to the argument that dynamism, though a cause of some fluctuation and some irremediable inequalities, is necessary for our health – for the good life. An economy of dynamism meets some of our very basic needs: to exercise our imagination, to enjoy the mental stimulus of change, to have an endless series of new problems to solve, to expand our capabilities, to feel the thrill of discovery, and to sense our personal growth.

What about inclusion?I would think it is not necessary in front of this learned audience of humanists and political philosophers to dwell very long on the importance of inclusion. But I would like to review the elements.

When I began promoting government measures to increase inclusion, at the beginning of the 1990s, my first argument was the Smithian argument that it is more effective in trying a raise a person’s income to enlist his self-help alongside your own contribution rather than simply to throw money at him unconditionally, which would probably diminish his motivation to earn additional income.

Later I came to emphasize in my book *Rewarding Work* (1997) that people in our society who are of sound mind and body but unable to gain employment – or are in and out of employment for any of a variety of reasons – suffer a loss of dignity, their self-respect and their sense of part of something going on in society.

Economic justice, as John Rawls would have said, requires us to help people into employment in order to boost their self-respect.

But I also began to see that inclusion in the economy is also of central importance to people because, for most of us, jobs are virtually the only source of mental stimulation, problems to solve, expansion of talents and self-discovery that we are likely to find. Because the more fortunate of the advanced economy are full of dynamism, it is particularly important in those economies that people be able to participate in the economy.

So the moral necessity of dynamism and the moral necessity of inclusion in a dynamic economy spring from the same considerations. It is a kind of death not to be able to have job satisfaction, employee engagement and the sense of development that results.

I have gone on to argue that dynamism boosts inclusion – even without any government policies to aid inclusion.

I have also come to see very recently that inclusion is likely to be quite a boost to dynamism.