Review Essay

The Ethical Economist

Growth May Be Everything, but It's Not the Only Thing

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The Moral Consequences of Economic Growth. BY BENJAMIN M. FRIEDMAN. Knopf, 2005, 592 pp. $35.00.

Economists have long been a natural constituency in favor of growth. Since even the richest country has limited resources, the central economic problem is choice: Shall we fund tax cuts for the rich or investment in infrastructure and research and development, war in Iraq or assistance for the poor in developing countries and our own? By providing more total resources, growth should, in theory, make these choices less painful.

The United States, however, has powerfully demonstrated that while growth increases supply, it also raises aspirations. Choices that rich countries have to make thus seem to be no easier than those confronting poor countries, even though the tradeoffs are more heart-wrenching in the case of the poor. Brazil, for example, must choose whether to use its limited health budget to pay full-market price for AIDS drugs; some AIDS victims may live as a result, but people in need of other health care will die, because money that could have been spent on their needs is simply not there. More growth-provided resources, in this instance, mean the difference between life and death.

Still, growth has had its critics. There is a well-developed populist antigrowth literature concerned with, among other things, the impact of growth on the environment and on poverty. In this major work, *The Moral Consequences of Economic Growth*, Benjamin Friedman takes on such critics, positing that

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growth has not only obvious economic benefits, but moral benefits as well. He argues that it has the potential to improve the environment, reduce poverty, promote democracy, and make for a more open and tolerant society. But this is not to say that Friedman, a professor of economics at Harvard University, is simply a naive cheerleader for the market economy. His message is nuanced (though not, in some respects, as nuanced as I would have liked), and he realizes that growth has not always brought the promised benefits. The market economy does not automatically guarantee growth, social justice, or even economic efficiency; achieving those ends requires that government play an important role.

LET IT GROW

Historically, economists have questioned whether, at least in the early stages of development, growth is accompanied by societal goods such as greater equality and a better environment. Nobel Prize–winning economist Simon Kuznets argued, based on experiences largely before World War II, that there is an increase in inequality in the early stages of development. Arthur Lewis, another Nobel economist, went further: greater inequality, he argued, is *necessary* to generate the savings that growth requires. A later generation of economists has posited the existence of an environmental Kuznets curve: the early stages of growth cause environmental degradation, not environmental health.

Kuznets and his descendants held out the prospect that eventually growth would bring more social justice (greater equality, less poverty) and a better environment. But there is nothing inevitable about this—which means that even if it has been true in the past, it may not be in the future. Inequality did seem to fall in the United States after the Great Depression, but in the last 30 years it has increased enormously. Many forms of pollution have gone down as richer countries have turned their mind to air-quality issues, but greenhouse gas emissions—with all the dangers they present for global warming—have continued to increase with economic growth, especially in the United States.

Friedman emphasizes in particular the importance of externalities—instances in which an economic actor's actions have consequences for others for which that actor does not pay (negative externalities) or for which he is not compensated (positive externalities). Almost everyone recognizes these "market failures" (when markets on their own do not produce efficient outcomes) and their implications, most notably damage to the environment. The United States' production of greenhouse gases imposes staggering costs on others—especially low-lying islands that will be inundated in the not-too-distant future—but American firms and consumers do not pay for these costs. Correcting such a market failure does not require subsidies to oil companies to increase oil production (there is no market failure in that direction); it requires more conservation. But externalities imply a more general argument as well: if growth has broad-based societal benefits that go beyond those captured by each individual or firm, then there is a role for government in promoting growth.

Although one of these broader societal benefits is a more open and tolerant society, Friedman explains carefully that the relationship between democracy and growth is two-way: growth affects democracy; democracy affects growth. Both aspects of the relationship are complex and often ambiguous. China—not particularly democratic or open politically—has had the most rapid and sustained growth of any country over the past quarter century. Conventional wisdom holds that democracies, since they are more accountable to the "masses," pay more attention to the poor. But China has done more to reduce poverty than most other countries. In recent periods, the United States has seen median real household income fall, and the rich have received huge tax cuts even as poverty has grown.

Unlike so many growth proponents, Friedman realizes that what matters is not simply growth; it is the policies that give rise to it. His work thus provides an important critique of those studies (such as at least one prominent World Bank study by Paul Collier and David Dollar) that correlate growth and poverty reduction or growth and integration into the global economy. For the most part, the policy decision facing governments is not to grow or not to grow or to integrate or not to integrate (though politicians often try to oversimplify in that way). The questions are more specific: whether or not to reduce tariffs, whether or not to liberalize capital markets, whether or not to invest more in research and development, whether or not to spend more on education. And the answers are less clear. Some of these policies may promote growth in ways that will increase poverty; others may promote growth in ways that will reduce it. Some growth strategies may be good for the environment; others may not be.

In short, the debate should not be centered on whether one is in favor of growth or against it. The question should be, are there policies that can promote what might be called moral growth—growth that is sustainable, that increases living standards not just today but for future generations as well, and that leads to a more tolerant, open society? Also, what can be done to ensure that the benefits of growth are shared equitably, creating a society with more social justice and solidarity rather than one with deep rifts and cleavages of the kind that became so apparent in New Orleans in the aftermath of Hurricane Katrina?

The problem is that most of the available empirical evidence comes from cross-country analyses, which are not very informative. Friedman's work provides an important reiteration of recent calls by the World Bank for more micro-level and case-study-based research on the potential tradeoffs between growth and poverty reduction and environmental quality.

THE INCOME SWEEPSTAKES

Friedman ends his book, which covers a delightfully wide range of topics, with an analysis of the kinds of policies that the United States might pursue to achieve his vision of moral growth. This discussion is simultaneously optimistic and pessimistic. The policies are clearly within our grasp. Yet they are a far cry from the policies the United States has been pursuing in recent years—which have led to a double whammy, simultaneously stifling growth (the most damaging consequences of which may lie years in the future) and creating a society marked by greater social injustice.

Among the developed countries, the United States has been doing well in the growth sweepstakes—or so you might assume if you focused exclusively on GDP. GDP statistics, however, can be very misleading. They do not really measure how well the country is doing or how much better off its citizens are becoming.

No one would look at just a firm's revenues to assess how well it was doing. Far more relevant is the balance sheet, which shows assets and liabilities. That is also true for a country. Argentina grew rapidly in the early 1990s, mainly as a result of a huge consumption binge financed by international borrowing. But that growth was not sustainable and was not sustained. Similarly, the United States has been borrowing heavily from abroad, at the rate of $2 billion a day. It would be one thing if this were being spent on high-productivity investment. In fact, it has been used to finance increases in consumption and massive tax cuts for upper-income Americans.

Consider the following thought experiment: If you could choose which country to live in but would be assigned an income randomly from within that country's income distribution, would you choose the country with the highest GDP per capita? No. More relevant to that decision is median income (the income level that 50 percent of the population is below and 50 percent is above). As the income distribution becomes increasingly skewed, with an increasing share of the wealth and income in the hands of those at the top, the median falls further and further below the mean. That is why, even as per capita GDP has been increasing in the United States, U.S. median household income has actually been falling.

There are other reasons why someone might not want to look at just per capita GDP. He might worry about his security. What happens if he gets ill? If he loses his job? What happens when he retires? He might worry about crime. He might worry about the quality of his children's schooling. How do his children fare in competition with those who can afford the best schooling that money can buy or with those in countries such as Singapore that offer a first-rate public education? He might worry about the environment. Are there government regulations prohibiting arsenic in the water?

When viewed through these lenses, the United States does not look as good. There are some dimensions in which it is outpacing others—for instance, it boasts five to ten times the per capita prison population of other advanced industrialized countries and more working hours per week. It also has less job security, worse unemployment insurance, and fewer people covered by health insurance.

To be sure, the American dream still attracts millions from around the world. But some of that attraction may be based on a lingering myth of upward mobility in the United States and an underappreciation of the difficulties that confront the poor. And although there is still no comparing the U.S. standard of living and that of poor countries, these are not the laurels on which one wants to rest.

HALF STEPS AND MISSTEPS

In the debate on the impact of globalization on poverty, Friedman supports the view that even if globalization has been associated with increases in inequality within countries, it has led to reductions in poverty and inequality globally. There are three fundamental flaws in this analysis. The first relates to the definition of poverty. As the World Bank has emphasized at various points, poverty is not just a matter of income; insecurity and voicelessness are also part of its profile. Friedman's analysis completely ignores these other dimensions.

The second criticism relates to the point that what matters is not globalization per se, but specific policies associated with it. Capital market liberalization, for example, entails closer integration of capital markets, especially with respect to short-term capital flows. Modern economic theory and empirical analysis have shown that with imperfect capital markets, such integration may lead to greater economic volatility—a conclusion that even the International Monetary Fund now supports—and has a negligible effect on growth. Furthermore, there is ample evidence that the poor bear the brunt of the burden from increased volatility. In short, this particular aspect of economic integration increases poverty without much affecting growth.

The third is that Friedman relies too heavily on studies by Xavier Sala-i-Martin (*The Disturbing "Rise" of Global Income Inequality*) and Surjit Bhalla (*Imagine There's No Country: Poverty, Inequality, and Growth in the Era of Globalization*) that have been subject to enormous criticism, without warning the reader of the debate surrounding their numbers. (It should be said that having an article published in a peer-reviewed academic journal and its conclusions parroted in the media does not imply automatic certification of its validity.) The problem is easy to state but hard to rectify: studies of inequality and poverty are based on household surveys of expenditures and income, but the numbers gleaned from those studies tend to be inconsistent with national income accounts, an outcome that suggests massive underreporting in the household surveys. One simple solution to this discrepancy—the approach largely used in the Sala-i-Martin and Bhalla studies—is to blow up the numbers from the household surveys. If the average income reported is $3,000 and national income accounts show average incomes to be $4,000, increase everyone's reported income by a third. This immediately reduces the figure for the number of people living in poverty.

However, more sophisticated approaches observe that higher-income individuals are more likely to worry about tax collectors than are the poor. In this view, the shortfall in reporting is largely accounted for by those with higher incomes, and the number for those reportedly living in poverty according to the household surveys is roughly accurate. Assessments of reporting "errors" support this view—a view that says the world still has a long way to go in meeting its goal of reducing poverty by half by the year 2015. (For a discussion of both sides of this issue, see the forthcoming *Debates on the Measurement of Poverty*, a volume produced by the Initiative for Policy Dialogue, which I edited along with Paul Segal and Sudhir Anand.)

Meanwhile, Friedman's contention that growth brings with it the virtues of greater openness and tolerance invites these questions: Is the United States, as it becomes richer, becoming more open and tolerant? Do openness and tolerance entail putting equal weight on modern science and pre-Enlightenment views?

Friedman is right, however, in arguing that democracy is less sustainable in poor countries. Thus, if Bush were serious about his commitment to spreading democracy, he would invest more in these countries' development, living up to the agreement made by all the advanced industrialized countries to commit 0.7 percent of their GDP to foreign assistance. The money would make an enormous difference, both for the quality of lives in the developing world and for the prospects of democracy there. Of course, more than just money is required: nothing is more convincing than successful examples of open and tolerant societies that are able to bring the fruits of growth and democracy to all their people. How can the United States claim to provide such an example if it does not take care of its own?

THE MYTH OF THE INVISIBLE HAND

American economists tend to have a strong aversion to advocating government intervention. Their basic presumption is often that markets generally work by themselves and that there are just a few limited instances in which government action is needed to correct market failure; government economic policy, the thinking goes, should include only minimal intervention to ensure economic efficiency.

The intellectual foundations for this presumption are weak. In a market economy with imperfect and asymmetric information and incomplete markets—which is to say, every market economy—the reason that Adam Smith's invisible hand is invisible is that it does not exist. Economies are not efficient on their own. This recognition inevitably leads to the conclusion that there is a potentially significant role for government.

Friedman, as a good American economist, begins his discussion by paying homage to the usual strictures, identifying externalities of the kind that warrant government intervention. He goes on to point out the importance of investment, both in physical and human capital, and to note that huge government deficits ("dissaving" on the part of government) are hurting those investments. A perfect market economist would dismiss this claim as nonsense: private savings will eventually increase to offset negative government savings, and if citizens want to consume more and save less now, that is their prerogative—just because Friedman wants to consume less today does not mean that he should be allowed to impose his preferences on the rest of us. Moreover, such an economist would say that it is not domestic savings that matter in our globalized world, but the global balance of supply and demand for funds.

Perhaps Friedman does not spend time refuting these perspectives because, notwithstanding the significant role they play in academic debates, they are so patently absurd. Of course private saving has not offset public dissaving on a one-to-one basis. Of course domestic saving matters for domestic investment, even in a globalized world. But it is important to grasp the reason why the predictions of the perfect-market models fall so short: market failures go well beyond externalities. Understanding these limitations of the market leads to an understanding of the necessary role of government in promoting growth and making sure that it is the right kind.

There is, for instance, a greater role for government in promoting science and technology than Friedman seems to suggest. A report by the Council of Economic Advisers (conducted when I was its chair) found that the returns on public investment in science and technology were far higher than for private investment in these areas and than for conventional investment in plant and equipment. So, too, with education, especially at a time of such concern with the quality of American schools, and particularly for low-income families. Vouchers—what amounts to partial privatization of our elementary and secondary educational systems—have been put forward as a free-market solution to the shortfalls in educational quality. But the advocates of vouchers have never made a convincing case that they can be designed to promote higher educational attainments and greater racial integration across the entire educational system, rather than just for those receiving the vouchers.

Friedman's book is thus an important antidote to the populist antigrowth movement and also to those who say that the free market is all we need. It joins a growing chorus calling for a change in the direction of U.S. economic policy—toward achieving growth that is stronger and more sustainable. Whether or not you agree with Friedman's particular policy prescriptions, this much is clear: this kind of reasoned analysis is precisely what is necessary to put the United States back on the right track.