Review article

In the Tradition of 'Magnificent Dynamics'

The Moral Consequences of Economic Growth
by Benjamin M Friedman;
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In an age when economic writing finds itself virtually polarised into the rigid formalism of professional journals on the one hand, and the chatty triviality of business newspapers on the other, one often longs for a book that would steer clear of either extreme, provide an enlightening perspective on issues of topical significance and reward the reader with material for serious reflection. Benjamin Friedman's recent book does all this and much more.

The growth of nations constituted the central focus of study for the founding fathers of classical economics with Smith, Ricardo, Marx and Malthus all making significant contributions. In a once popular book (which is rarely read now) but which still retains much of its sheen, Baumol (1951) had called this variety of growth economics "magnificent dynamics". Under the influence of marginalists like Jevons, Clarke and Marshall in the closing decades of the 19th century, interest in growth issues somewhat flagged. Later, Keynesian theory almost made growth a non-issue with its exclusive concern with short-term issues of stabilisation policy (and, perhaps, even more with Keynes' characteristic jibe about all of us being "dead in the long-run"). Revival of growth theory in the 1950s and 1960s coincided with the emergence of mixed economic systems in several of the newly liberated colonies. This growth theory, as expounded in the works of Harrod, Kaldor, Robinson, Solow, Swan and others largely remained a formal and esoteric field. The east Asian economic miracle of the 1970s, and more recently the growth surges in China (and to some extent, India) have revived academic interest in growth issues, though this time, with a decidedly empirical orientation. However, much of the academic literature still remains narrowly focused theoretically and over-reliant on empirical methods, which often seriously strain econometric etiquette, by operating on questionable data with sparse degrees of freedom. But perhaps, the greatest flaw of much of this literature lies in its "a-historic" approach, with a corresponding neglect of vital socio-political and other institutional features characterising individual growth experiences. Occasionally, it is true, attempts are indeed made to incorporate such features but these are hardly satisfactory, considering the rather crude fashion followed in most studies, of introducing sweeping broad proxies (for socio-political variables) in cross-country regressions.

Friedman's book marks an important break from this stereotyped mould by adopting an approach much in the spirit of the magnificent dynamics of the classical writers, with this important difference that whereas the classicals focused on the causal factors underlying the growth process, Friedman is more interested in the consequences of this process. Like the classicals, however, his canvas is amazingly broad, encompassing historical trends, political institutions and social and cultural contexts of individual nations. His book thus becomes a rewarding reading experience, offering rich insights into historical growth epochs, even though one may not be in full agreement with all his conclusions.

Friedman's central thesis is simple and straightforward and may be stated (at the risk of some over-simplification) in terms of three propositions: (i) economic growth (meaning a rising standard of living for the clear majority of citizens) fosters greater opportunity, social mobility and most other desirable attributes of democracy; (ii) contrary to the popular belief among western economists that growth is best left to market forces with minimal government interference, Friedman actually argues that the potential rate of economic growth is greater than the purely market-determined rate, and suitably devised government policies can bolster this rate; and (iii) consumerism per se is not morally reprehensible and may often bring in its wake more open, and tolerant attitudes. (Friedman himself does not use the term "consumerism", referring instead to the issue as a false choice between material positives and moral negatives.)

Each of these propositions is eminently debatable. But before passing on to a discussion of these propositions, it may be worthwhile to clearly enunciate Friedman's concept of morality. Friedman adopts a position, which can be described as absolutist and close in spirit to the liberal ideal of the Enlightenment philosophers, embracing "openness of opportunity, tolerance, economic and social mobility, fairness, and democracy". This is in contrast to relativist moral philosophies such as those of Hume, Westermarck or Perry (who tended to emphasise culture specific aspects of morality) as also to other absolutist moral philosophers such as Tolstoy and Gandhi, who lay great stress on individual morality in social arrangements. A large part of the differences in the perceptions of austerity in Friedman and other moral philosophers could be traced to this semantic difference.

Growth, Poverty and Inequality

If economic growth is to have favourable moral consequences (once again invoking the term in Friedman's sense), then it should result in appreciable reduction of poverty and inequality. Friedman is fully cognisant of this, and devotes a great deal of attention to these aspects throughout the book especially in part IV. His major premise is that economic growth does accelerate poverty reduction, which he substantiates with an impressive amount of empirical evidence. "It is clear that over time economic growth, in the familiar sense of a rising per capita income, enables ever more citizens of a developing country to escape the sorry conditions that make up the everyday burdens and genuine miseries of poverty" (p 357). The general issue of growth and poverty alleviation has recently generated a great deal of theoretical and empirical literature, and I cite from some of this voluminous literature, in an attempt to put Friedman's conclusions in perspective. Kraay (2005), for example, has shown that poverty changes in any country can be decomposed into three ingredients: (i) growth in per capita income; (ii) elasticity of poverty reduction with respect to growth; and (iii) changes in income distribution. Using a cross-country sample, Kraay finds that about 70 per cent of the medium-term variation (and 95 per cent of the long-term variation) in headcount poverty changes are attributable to the growth factor alone, with the other factors playing a marginal role. (However, as stressed by Bourguignon (2003), such a decomposition is purely arithmetic and does not enlighten us much on the underlying relationship between growth and poverty.) Poverty figures in India are fiercely debated but going by the latest statistics (61st National Samply Survey round 2004-05), the decline in aggregate poverty (by nearly 8 per cent over an 11-year span 1993-94 to 2004-05) has fallen considerably short of the expectations generated by the "high growth miracle".

There is an essential dimension to the social welfare aspects of economic growth, which receives a somewhat inadequate treatment in Friedman's book, viz, the problem of unemployment. The chronically unemployed (in the working group age) with typically low self-respect have little likelihood of exercising their civil rights in a responsible manner. If growth aggravates chronic unemployment, then, even if it makes a strong dent in poverty, the overall impact on social welfare is questionable. Many observers fear that unemployment is ultimately likely to prove the Achilles' heel of the ongoing reforms process in several countries (India being a prominent example). It is now unequivocally accepted that the move to market-friendly policies globally, has reduced the employment elasticity of growth in less developed countries (LDCs), in ex-socialist countries as well as the Organisation for Economic Cooperation and Development (OECD) group of countries. Even in China, spectacular growth has coexisted with an urban unemployment problem. The aggravation of the unemployment problem occurs through several channels, the main ones for the LDCs being the following:

(1) A decline in the terms of trade (ratio of export prices to import prices) owing to the low level of demand for LDC exports in the advanced countries.

(2) Corporate restructuring and mergers and acquisitions.

(3) Rapid growth of labour-saving technologies, mainly introduced into LDCs by multinationals.

(4) The global spread of new technologies has brought in its wake a new underclass of "the learning-disabled" consisting of the least educated older workers. This class is not only the unemployed but also "unemployable" – in the globalised world there being no room for the totally unskilled worker.

Of course, there is an element of truth in the claim often made by the growth enthusiasts that although new technology displaces labour, it also lowers costs and prices, and hence, expands the demand for labour in the long run. But it should be emphasised that with each successive wave of technology, the new demand is going to be for increasingly skilled workers. In the absence of a suitable education and training policy, the already displaced labour cannot be absorbed – only a skill-job mismatch situation develops with an excess demand for highly skilled workers co-existing with a vast army of the long-term unemployed.

There is by now, a fair degree of unanimity among economists that growth is essential for poverty reduction, under the assumption that the distribution of income remains constant [Deininger and Squire 1998, Dollar and Kraay 2002, etc]. However, as shown by Ravallion (2004) [also Bourguignon 2003] rapid poverty reduction will be hard to achieve, even in the face of high growth rates, if initial income inequality is substantial or if the growth process itself aggravates inequality. Thus, the main leg in the "poverty-growth-inequality triangle" (a concept due to Bourguignon (2004)) is that connecting growth and inequality.

Inequality is possibly one of the most neglected and least emphasised dimensions of the liberalisation programme in most LDCs. It becomes a crucial factor determining long-term sustainability of the reforms programme, because of several reasons. Firstly, as we have seen above, the impact of growth on poverty alleviation is critically dependent on the level of initial inequality in a society. Secondly, high levels of inequality are inhibitive of the development and survival of democratic norms in a society. Inequality undermines good public policy, by eroding collective decision-making processes and social institutions critical to a healthy functioning of democracy (the so-called "vanishing middle class" syndrome as discussed in Nancy Birdsall (2005)). This view is also very strongly shared by Friedman.

A More Contentious Issue

The relationship between inequality and economic growth is a more contentious issue on which at least two major schools of thought are apparent. The early work in this area was heavily influenced by Kuznets (1955), wherein an inverted U-shaped curve was posited (and empirically sustained) between inequality and economic growth, i e, increasing levels of per capita income are initially accompanied by rising inequality and subsequently, the relationship was reversed. As is well known, Kuznet's explanation ran in terms of physical investment as the main driver of growth in the early stages, with investment in human capital assuming importance as the economy matured. While it is not clear what is the exact direction of causation envisaged in the Kuznets curve, modern analysts have tended to view the degree of inequality, if not exactly as a political datum, at least as something which is difficult to derive from purely economic considerations. This leads them to focus on how inequality affects growth rather than the other way around.

Theoretical literature presents several interesting perspectives. Theories which predicate a growth-retarding role for inequality, typically focus on the ideal rate of taxation for different individuals [Alesina and Rodrik 1994; Persson and Tabellini 1994; Bertola 1993, etc]. The higher the income that an individual derives from capital, the greater his preferences for lower tax rates on capital (which favour growth). The more equitable the societal income distribution, the higher the median voter's capital endowment, thus (by the median voter theorem) favouring growth enhancing policies. But this result is extremely sensitive to the underlying assumptions. Saint-Paul and Verdier (1993), for example, show that if the tax on capital is used to finance public education, the same reasoning could lead to a benevolent link from inequality to growth. Several other theoretical models of the link between inequality and growth have been advanced in the literature. Galor and Tsiddon (1997), for example, argue that inequality increases during periods of major technological innovations, which enhances concentration of high-skilled workers in technologically advanced sectors, leading to further growth acceleration. Murphy et al (1989) explored the role of income distribution in influencing the size of home demand and the potential for industrialisation, while Galor and Zeira (1993) show how liquidity considerations affect the relationship between growth and inequality by determining the share of population that can invest in education. By and large, the empirical work in this area tends to be supportive of inequality being detrimental to growth [Persson and Tabellini 1994; Birdsall et al 1995; Benabou 1996; Deininger and Squire 1998, etc], a view also emerging robustly in Friedman's detailed historical evaluations. Friedman thus comes out strongly in favour of equality both on instrumental (growth promoting role) grounds, as well as being desirable for its own sake. But the key issue for social welfare is how growth affects inequality and here the strategy followed for growth assumes overarching significance. On this point however, there is little elucidation in the book. Lopez and Serven (2006) have given several illustrations of growth objectives in conflict with poverty reduction and equity objectives. Among the important trade offs that they identify are the following: (i) higher spending on poverty-related projects (rural infrastructure and housing, education, health, etc) versus the dictates of fiscal prudence; (ii) capital account liberalisation versus locking up of funds in forex reserves; and (iii) protecting property rights of peasants versus the creation of special economic zones for foreign investors. Firm conclusions about the moral impacts of economic growth thus cannot be inferred unless we have a clear idea of the precise trajectory of the growth process.

Rising Living Standards and Morality

The issue of whether increased material prosperity (and general economic development) strengthens the various dimensions of morality (as per Friedman's definition) of a society, may seem to have a straightforward affirmative answer. Indeed Aristotle (1962, 330 BC) had argued that only a wealthy society provided the opportunity for intelligent participation in public affairs, to a majority of its citizens. It is difficult to disagree with Lipset's (1959) observation that, "A society divided between a large impoverished mass and a small favoured elite would result either in oligarchy (dictatorial rule of the small upper stratum) or in tyranny (popularly based dictatorship)".

But while a minimal level of development might be necessary for the existence of democracy and other moral attributes, the question of whether material development beyond the sustenance level sets in motion forces favourable to the emergence of such attributes, is a far more complex question. Friedman has adduced historical evidence to the effect that improved living standards bring about positive changes in social values and raise the standard of political institutions. Similar views have been advanced by Przeworski and Limongi (1995), Rueschemeyer et al (1992) and Lipset (1994). In general, these explanations predicate that economic growth brings in its wake greater equality of distribution, better communication, literacy and education. In Lipset's words "…the rise of capitalism, a large middle class, an organised working class, increased wealth and education are associated with secularism and the institutions of civil society, …which facilitate other preconditions for democracy" [Lipset 1994, p 7].

Friedman's position is, in spirit close to the views of classical thinkers such as Condorcet, Montesquieu and Adam Smith, who stressed "the civilising effects of commerce" [Hirschman 1986]. Several political theorists, spanning a spectrum of ideologies from Marx to John Stuart Mill, have, by contrast, viewed capitalist development as leading to crass materialism, corrosion of morality and an undermining of individual liberty. As is well known, Marx (1932, original publication 1872) saw economic development and industrialisation as culminating in a "dictatorship of the proletariat" whereas Weber (1922 translated by Henderson and Parsons 1947) viewed it as likely to lead to a "dictatorship of a bureaucracy". Mill (1963, originally published 1848) warned against the excesses of the market, and while not completely discarding the capitalist order, vehemently argued for important reforms in the system, such as limitations on inheritance, the provision of higher quality education for all, and several other features of a welfare state socialism.

An important group of analysts has tried to explore whether the relationship between development and liberal attitudes depends on the stage, timing or path of development. Hirschman (1986), for example, suggests that the early stages of development seem to be supportive of liberal values, whereas the connection could become less pronounced or even perverse in the later stages of development [see also Almond 1991].

The issue of whether the timing of development is an important determinant of political liberalism has also attracted a great deal of attention. Two contending hypotheses have been advanced. Firstly, there is the hypothesis due to Schweinitz (1964) and Moore (1966) that the social, economic and political conditions that existed for the early developers were far more conducive to democracy than those confronting the late developers, so that the earlier a country embarks on a development path, the higher is its level of political democracy. As the direct antithesis of this hypothesis, Bendix (1976), Collier (1975), etc, argue that late developers face stronger pressures towards adopting libertarian ideals, because of cultural transmission of democratic ideas from the already developed democracies through the medium of books, television, education, etc. Bollen (1979) tried to examine both the hypotheses empirically from a cross country panel study, but found little empirical support for either. This, however, is an issue on which further empirical work is certainly called for.

The strategy of development and the implied growth path could also be important considerations in the political outcome. Roemer (1995) develops a formal model, in which the crucial impetus for political transformation comes from important changes in citizen preferences, especially as regards civil liberties. His general conclusion is that political outcomes (or more specifically the emergence of democratic attitudes) are path dependent. Some development paths (such as those based on increasing capital stock, increasing labour productivity or decreased inequality of wealth) could even lead to a perverse relationship between development and democratic attitudes. His explanation is that those development paths, which decrease the costs associated with political uncertainty are the ones likely to foster democracy, while others might be antithetical to the fostering of liberal attitudes.

The above discussion serves to indicate that the relationship between political liberalism (or morality in Friedman's sense) and economic development is an extremely complex one, and one which might be difficult to unravel from highly simplified econometric models, which seem to be the flavour of many of the studies undertaken in this area (though Friedman himself steers clear of this route). Country studies paying in-depth attention to institutional details (in the spirit of the book under review) might offer a more promising line of inquiry.

Pro-Growth Government Intervention in Markets

One aspect of the case for government intervention in markets to foster growth as made by Friedman (see p 402), would command wide acceptance. This refers to the prime cases of market failure, viz, technology. As is well known, technology partakes of the nature of a public good, which is subject to "knowledge" and "adoption" externalities [see, e g, Goulder and Schneider 1999, etc] and left to market forces, investment in research and development (R & D) will fall considerably short of the social optimum. Friedman lays emphasis on the role of government policy in encouraging technological advances (by measures such as patent protection, tax credits for R&D, etc) and human capital upgradation (through education) – and on this few will disagree with him.

However, Friedman's view that "there are plenty of ways in which governments at all levels could enable businesses to function more efficiently, primarily by easing regulation in any of a wide-variety of areas", is open to conflicting interpretations. On the one hand, deregulation measures aimed at promoting markets and competition could do the economy much good but in many countries (such as India) with a recently initiated liberalisation programme, the influence and lobbying power of multinational corporations and large corporations could be substantial. Deregulation measures in infrastructure sectors like power, airlines or telecom and in financial services areas (banking and insurance) while avowedly pro-market could in effect be pro-business, favouring specific business houses. (The Indian prime minister's recent reference to crony capitalism seems to indicate that distortions have crept into the ongoing Indian reforms process to a significant extent.) As a matter of fact, the real cause for concern in the recent reforms experience in south Asia generally, has been that in the post-reforms era, governments have attempted to progressively withdraw from areas like education, health and human resources development, generally where it could play a potentially benevolent role but has continued to make pro-corporate interventions in key areas related to infrastructure and financial services. By and large, I feel hesitant to accept the clear-cut case that Friedman makes for government intervention to promote market-oriented growth.

It is evident that when Friedman talks about the beneficial effects of consumerism and material growth ushering in a more open and free society, he has the Chinese example uppermost in his mind. And certainly within the Chinese context, his claim seems irrefutable. However, in societies like India, which have always enjoyed a fair amount of democratic rights, a consumerist ideology may have little additional contributions in this way. What exactly would then be the moral implications of globally driven consumerism in a country like India? The answer depends on what definition of morality one adopts. Friedman's conclusions about a consumerist growth (in conjunction with globalisation) strengthening democratic attitudes may be viewed as part of a broader consensus among western political scientists.

A Moral Point of View

However, it is not exactly clear whether Friedman's conclusions can be extrapolated to other definitions of morality (discussed above) which lay greater stress on private attitudes or are more culture specific. Most of the opposition to consumerism really comes from those who view consumerism as eroding private morality or as threatening local cultures, styles of living, etc. From a historical perspective, two schools of thought have been strongly opposed to consumerism, viz, Marxism and Altruism. Communist leaders like Lenin and Mao were anti-consumerist, partly because they saw high savings as the basic prerequisite for their prime objective of "catching up" with the western capitalist economies, and partly too due to their fear of imported consumer goods acting as harbingers of "new and dangerous ideas". Altruism by contrast focuses on the "degenerative moral effects" of self-centred consumerism on the individual. Friedman has gone to considerable lengths to convincingly meet the Marxian critique of consumerism in his book (pp 327-69) but largely ignores the altruistic views of moral social philosophers such as Mahatma Gandhi, for example. Of course, altruistic economic philosophy in general or Mahatma Gandhi's economic thinking in particular, can hardly be said to be a part of western mainstream economic consciousness, and hence it would be unfair to blame Friedman for not taking any cognisance of this critique of consumerism. Nevertheless, considering the fact that Gandhi's views on consumerism have shaped attitudes to development, not only in India but in large parts of the third world, some discussion of this strand of thinking in Friedman's book would have been most welcome.

In the preface to his book, Friedman narrates how a European scholar with whom he discussed the outline of the book observed that "only an American – and at that, only an American of my generation – would write a book expressing such an optimistic perspective on economic growth from a moral point of view" (p x). Many in India (this reviewer not excluded) would find themselves similarly viewing the book as a rather optimistic perspective on growth. And yet almost everyone (once again, including this reviewer) would regard this book as a great contribution, in the tradition of Baumol's "magnificent dynamics", similar in breadth of vision to Schumpeter's *Capitalism, Socialism and Democracy* (1943), and an equally enriching reading experience. "Every citizen should read it" wrote the *New York Times* of Friedman's other book *Day of Reckoning*. I am tempted to reiterate the *New York Times* exhortation, for this book, only more forcefully. My only fear is that the current breed of Indian growth fetishists, with their proclivities for selective "cherry-picking" might view this book as an endorsement of their naïve views, turning a convenient blind eye to the many elaborate caveats and nuances, with which Friedman so carefully qualifies his conclusions. EPW

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