

The Political Forum

*A review of social and political trends and events
impacting the world's financial markets*

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Do George, Bill Or Ross Have The Key To Economic Growth? Would They Know It If They Saw It?

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Two of the most important questions facing global investors in the 1990s are the following.

- o Can the U.S. economy produce healthy economic growth, despite rapid expansion in the service sector where productivity gains are difficult to achieve?
- o With the adoption of capitalism as a model for governmental restructuring in the Soviet Union, Eastern Europe and other socialist countries all over the world, which of these newly emerging "capitalist" nations will produce the fastest economic growth and which will disappoint?

Unfortunately, to speculate intelligently about the answers to these questions one must rely heavily on the process of interpreting the intentions, promises and actions of politicians. In the old Eastern bloc and in Latin America, this is virtually impossible due to the amazing hodgepodge of allegedly capitalist economic schemes that are being both tried and promised.

The situation in the United States is no less clear. Judging from political pronouncements to date, President Bush hasn't given the matter much thought, except to mouth an occasional inanity about how everything would be dandy if we just had a lower capital gains tax.

And of course, over at Bush's Office of Management and Budget, described by the conservative newspaper *Human Events* as Dick Darman's "little shop of horrors," we hear a cry in favor of a balanced budget amendment to the constitution, a sort of "stop me before I kill again" solution to the deficit problem.

Ross Perot and Bill Clinton, on the other hand, seem to have thought too much about the issue. Both have embraced radical departures from traditional capitalist economic models, advocating

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restricted trade with such countries as Mexico, and the establishment of elaborate industrial policies that would put the full power of the government behind those industries that Washington's bureaucrats happen to favor at any given time.

But even if one had a crystal ball and could accurately foresee the details of the economic programs that will be employed during the 1990s in the United States and in each foreign nation, there is the additional problem of then determining whether these schemes will have the desired effect of inducing growth.

I have always believed that there is a direct positive correlation between prosperity in a nation and the amount of economic freedom present there. So one approach would be to attempt to rate the quality of capitalism in each nation; or to put it another way, the degree to which government interferes negatively in commerce by passing laws that penalize capital accumulation, restrict trade, overindulge the labor force, and over regulate the market and workplace.

The problem with this approach is obvious. The quality of capitalism is difficult to quantify in established market societies, and it would be virtually impossible to do so in the socialist-to-capitalist transitional nations.

So what does one do? Funny you should ask. I recommend the work of Paul Romer, a professor at the University of California at Berkeley and a fellow of the Canadian Institute for Advanced Research. Romer doesn't provide concrete answers to my two opening questions. But he does furnish an excellent basis from which to appraise the mutterings of our presidential candidates on the subject of economic growth and the prospects for growth in former socialist nations that are staggering toward capitalism.

I couldn't even begin here to do justice to Romer's heavily quantified "new growth" theories. But basically, Romer argues that human capital and technology are as crucial to economic growth as are monetary capital and labor, the two principle factors considered by neo-classical economics to be the keys to growth.

His theories lead inescapably to the conclusion that nations wishing to achieve healthy economic growth must aggressively invest in education, must invest the resultant human resources in technology and then protect that technology as a national asset. He also makes a strong case that open markets are an absolute must for healthy economic growth.

Romer defines human capital as "a distinct measure of the cumulative effect of activities such as formal education and on-the-job training." As for technology, Romer is interested exclusively in what he calls "partially excludable, non-rival" knowledge, i.e. that which can be protected from unauthorized use and which can be used by many firms at the same time.

In a paper from the National Bureau of Economic Research entitled "Endogenous Technological Change," Romer summarizes the conclusions from his model this way.

"Growth . . . is driven by technological change that arises from intentional investment decisions made by profit-maximizing agents . . . that the stock of human capital

determines the rate of growth, that too little human capital is devoted to research in equilibrium, that integration into world markets will increase growth rates, and that having a large population is not sufficient to generate growth."

His argument, he says, is based on three premises. The first is that technological change lies at the heart of economic growth because it provides the incentive for continued capital accumulation, and together, capital accumulation and technological change account for much of the increase in output per hour worked.

The second premise is that technological change arises in large part because of intentional actions taken by people who respond to market incentives. This does not mean, he says, that everyone who contributes to technological change is motivated by market incentives. Romer notes that an academic scientist who is supported by government grants may be totally insulated from them. But, he says, the premise is that market incentives nonetheless play an essential role in the process whereby new knowledge is translated into goods with practical value.

Finally, Romer states his most fundamental premise, that technological change (which he describes as "instructions for working with raw materials") is inherently different from other economic goods in that once the cost of creating a new set of instructions has been incurred, the instructions can be used over and over again at no additional cost. Thus, he says, developing new technology is equivalent to incurring a fixed cost.

From this final point, Romer notes that various economic studies show that gains from fixed costs are directly related to market size, and thus are enhanced by trade between countries. His model, he says, shows that increases in the size of the market have effects not only on the level of income and welfare but also on the rate of growth. Larger markets, he notes, induce more research and faster growth.

Romer introduces a cautionary note here, however. He says the size of the population with which a nation trades is not as important as the stock of human capital in that country. "If access to a large number of workers or consumers were all that mattered," Romer says, "having a large population would be a good substitute for trade with other nations." This, he says, explains why the presence of a large domestic market such as China or India is not a substitute for trade with the rest of the world. In the case of the world's poorest nations, Romer says, "if the stock of human capital is too low, growth may not take place at all."

In conclusion, Romer notes the following. (Please pay attention here, Bush, Clinton and Perot, if you're out there somewhere and sentient.)

"The most robust welfare conclusion from the model is that because research projects exchange current costs for a stream of benefits in the future, the rate of technological change is sensitive to the rate of interest.

"Although all the research is embodied in capital goods, a subsidy to physical capital accumulation may be a very poor substitute for direct subsidies that increase the incentive to undertake research. In the absence of feasible policies that can remove the

divergence between the social and private returns to research, a second best policy would be to subsidize the accumulation of total human capital.

"The most interesting positive implication of the model is that an economy with a larger total stock of human capital will experience faster growth. It also suggests a way to understand what it is about developed economies in the twentieth century that permitted rates of growth of income per capita that are unprecedented in human history.

"The model also suggests that low levels of human capital may help explain why growth is not observed in underdeveloped economies that are closed and why a less developed economy with a very large population can still benefit from economic integration with the rest of the world."

Where all this leads, of course, is that we should be distrustful of presidential candidates who concentrate their rhetoric on the welfare of individuals rather than on the long-term importance to these individuals of a government that promotes research and development, education and international trade.

It also strongly hints that growth in the old communist nations isn't simply a matter of the market size and the availability of raw materials, but of the development of a society that will promote industry and innovation; that will put into place a legal system that will protect technological developments should they occur; and that will promote international trade.

In an article for the upcoming fall edition of the *Fortune Encyclopedia of Economics*, Romer puts it this way.

"A traditional explanation for the persistent poverty of many less developed countries is that they lack objects such as natural resources or capital goods. But Japan had little of either in 1950 and still has few natural resources, so something else must be involved. Increasingly, emphasis is shifting to the notion that it is ideas, not objects that poor countries lack.

"The knowledge needed to provide citizens of the poorest countries with a vastly improved standard of living already exists in the advanced countries. If a poor nation invests in education and does not destroy the incentives for its citizens to acquire ideas from the rest of the world, it can rapidly take advantage of the publicly available part of the worldwide stock of knowledge.

"If, in addition, it offers incentives for privately held ideas to be put to use within its borders (for example, by protecting foreign patents, copyrights and licenses, and by permitting direct investment by foreign firms.), its citizens can soon work in state-of-the-art production activities."

For developing countries like India, Romer maintains, "enormous increases in standards of living could be achieved merely by allowing in the ideas held by companies from industrialized nations. But leading countries like the United States and Canada, and new leaders like Japan,

cannot stay ahead merely by adopting ideas developed elsewhere. They must also offer incentives for the discovery of new ideas at home."

Romer acknowledges Japan's enormous success in developing technology. But he cautions the United States against the adopting a national industrial policy such as Japan has. The gains from applied research are largest, he says, not when it is dictated by government agency priorities or academic curiosity, but instead when it is closely integrated into the operations of a firm and motivated by the problems and opportunities that the firm faces."

He notes that a growing set of scandals involving bribe-taking politicians in Japan raises additional warning flags against emulating Japan. The Japanese, he says, are learning the same lesson we should have learned when members of congress intervened in the supervision of savings and loans: "If the government has important discretionary power over economic affairs, members of the government can all too easily divert that power from its intended public purposes and put it to private use." Amen!

"The challenge facing all industrialized nations, including Japan," Romer maintains, is "to invent new institutions that support a high level of applied, commercially relevant research in the private sector. These institutions must not impose high efficiency costs and, most important, must not be vulnerable to capture by narrow interests."

Are you listening, George, Bill and Ross? Or better yet, do you understand?

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