

Mass Flourishing: How Grassroots Innovation Created Jobs, Challenge, and Change

Edmund Phelps

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In his most recent tome, Edmund Phelps, the 2006 Nobel Laureate in Economic Science, addresses a topic crucial to successful national capitalist systems: the dynamics of the innovation process. Phelps develops his thesis around three main themes: In part one, he explains the development of the modern economies as they form the core of early–19th century societies in the West; in part two, he explores the lure of socialism and corporatism as competing systems to modern capitalism; and, in part three, he reviews post-1960s evidence of decline in dynamism in Western capitalist countries.

In the introduction, Phelps reviews available economic data on both output and real wages per worker in England during the era of “mercantile capitalism” (between 1500 and 1800), which emphasized the distribution of products to consumers. He concludes that “the mercantile economies brought strikingly few advances in economic knowledge.” Yet, the 19th century, specifically between 1820 and 1870, saw spectacular growth in two major economic indicators—output per head and average real wages—in America, France, Germany, and Great Britain. Phelps argues that “the explosions of economic knowledge in the 19th century must be the effect of the emergence of an entirely new economy: a system for the generation of endogenous (or ‘indigenous’) innovation.”

In part one, Phelps defines a modern economy as one with “a considerable degree of dynamism—that is, the will and the capacity and the aspiration to innovate.” Yet the foundation of dynamism is innovation, even on an international scale, where conception and development can originate in one nation while pioneering adoption takes place in another. Phelps argues that the dominant Schumpeterian model of punctuated equilibrium theory prevented economic thinkers from seriously considering a model of a modern economy generating economic knowledge through its own indigenous talent and insight into the innovation process.

However, unlike the scientism and historicism that came to rule academia, the modern economy empowers financiers, manufacturers, and consumers, whose ideas and deep personal engagement

create products and services and who have the responsibility to manage the innovation process from development to commercial adoption. This system fosters attitudes that attract innovators to novel opportunities and it generates the disruptive knowledge that gives the modern economy its dynamism. According to Phelps, the more an economy devotes itself to inventing and innovating, the more “modern” it is.

So how effective have modern economies been for their people? Phelps argues that the single most important economic indicator of material benefits is wages, and he reports that the daily wage per worker as a ratio to the national output per capita went up in France, Germany, and Great Britain from 1830 to 1910. That fact, coupled along with the aforementioned wage trend in the middle of the 19th century, led to two societal benefits: First, it allowed unskilled workers to accept more desirable work while also increasing economic mobility among all people; second, wages reduced poverty and improved public health and mortality. Through innovation, modern economies outperformed less-modern economies and significantly altered their material conditions of life.

As to nonmaterial benefits, modern economies transformed the work and careers of millions through self-actualization, employee engagement, self-expression, self-discovery, the freedom to act, and personal attainment. Moreover, there were three freedoms (“economic institutions”) that boosted dynamic economies: personal liberty (“self-ownership”), the legal right to accumulate income earned from commercializing a successful product, and the legal right to invest this income in private property. Furthermore, the economic institution of the business organization—the proprietorship, partnership, and the joint stock corporation (along with its limited liability)—and the political institution of representative democracy both played important roles.

In part two, Phelps explains the “lure of socialism,” which includes various factions, ranging from the extreme of communism (“centralized control of all enterprises”) to the Fabian socialists’ incremental reform in the scope of capitalism. On the economic failures of Marxian socialist economies in the 20th century, Phelps concludes that they were fatally lacking in dynamism, that is, the knowledge necessary to build a modern economy and the fundamental incentives necessary for managers to be entrepreneurial and innovative.

Corporatism, where the state is free to take whatever measures it chooses for the sake of solidarity and protection, is a late-19th century Western European criticism of the modern economy. Corporatists argued that the modern capitalist economy lacked leadership and direction. In the early 20th century, corporatism was entrenched in Fascist Italy, Nazi Germany, and to a lesser extent in Portugal and Ireland. In the United States, Phelps reports that the New Deal brought some corporatist initiatives, such as the National Labor Relations Act of 1935, which established the permanent right of employees to organize. Phelps believes, however, that a “new corporatism,” where “the state is less a guide choosing the heading than a pilot paid by the passengers to take them where they ask,” has alarmingly taken hold in the post-World War II American economy.

Based on economic data covering the period from the mid-1960s through the first decade of the 21st century, Phelps found that the relatively modern capitalist economies of the United States, Canada, Great Britain, and Norway consistently outperformed the relatively socialist-corporatist economies of Germany, France, Italy, and Spain on labor participation, inclusion, and productivity indicators. Furthermore, as to the development of indigenous innovation, Phelps concludes that the relatively corporatist economies performed less robustly because they lacked the economic institutions and culture to “enable, stimulate, and spur experimenting, exploring and trying things.”

The economic culture of a nation, consisting of prevailing attitudes, norms, and assumptions about business, work, and other aspects of the economy, “may affect the generation of nonmaterial rewards indirectly through their influence on the evolution of institutions and policies, but also very directly through their impact on participants’ motives and expectations.” To support his position, Phelps utilizes World Values Surveys (WVS) data for 1990–91 and 1999–2000 to argue that relatively modern capitalist countries that ranked highest in family satisfaction, including Denmark, Canada, the United States, and Ireland, also ranked highest in job satisfaction. Phelps identifies institutional causes of these nonmaterial disparities, such as recognizing stronger legal structures/property rights and establishing financial institutions, as well as cultural causes, including values associated with the interestingness of a job, acceptance of new ideas, the desire to have some personal initiative, a readiness to accept change, and a willingness to accept

competition—all WVS classifications representing modern capitalist values.

In part three, Phelps describes the alarming slowdown in average growth rates of American labor productivity beginning in the early 1970s and extending to 2011 and 2012. Labor productivity was 1.57 percent in 2011 and 2012, compared to 2.33 percent in 1891, and multifactor productivity was 1.17 percent in those same years, compared to 2.26 percent in 1922. He concludes that “the waning of innovation was largely behind the increased joblessness and downward pressure on wages that have been endemic to the post-1972 period.”

What factors are behind the post-1960s decline in the dynamism in the American modern capitalist economy? Economic institutional sources include: unnecessary and self-dealing managerial hierarchies in large companies, professional managers focused on short-termism at the expense of innovative long-term projects, and risk-averse mutual funds and large investment banks speculating in currencies and government bonds rather than evaluating companies and industries on their specific merits. The economic culture, specifically the litigiousness of American society and an entitlement attitude, also plays an important role in this decline. Lastly, Phelps observes a disturbing increase in corporatism between the state and business, that is, a “parallel economy” of political influencers seeking company advantage and actively repressing market competition and innovation.

Phelps engages the concept of the “good life” (and “good economy”) through a humanist lens, using Aristotle’s “pursuit of knowledge” as a departure point. He also explores the concept of pragmatism, which involves knowledge valued for its practical applications, but he admonishes that “pragmatists do not specify what humankind wants to succeed at.” Phelps clearly espouses an individualist approach to the good life found in the “vitalist” school, which translates *eudaimonia* to a broader concept of individual “flourishing” and “self-discovery” and attaining the “highest good” while still being an active participant in the modern economy.

Phelps embraces John Rawls’ distributive justice approach in evaluating the modern capitalist economy and applies this conception of (economic) justice to the distribution of the rewards from work. This includes “the avoidance, where practicable, of economic inefficiency” thus requiring, by definition, a form of market economy. Yet

Phelps acknowledges that the static (“having a future always foreseen”) Rawlsian version of a market economy is flawed, being neither innovative nor dynamic. While many critics of the modern capitalist economy advocate a “balance” between work and home (a traditionalist value), Phelps sees such personal challenges as part of the good life, and we “cannot expect to find more flourishing by cutting back on challenges and hurdles.” He views the freedom and justice found in a modern economic society as the coexistence of traditional and modern economic values—entailing costs individuals must personally accept.

In his epilogue, Phelps identifies his policy prescriptions for restoring dynamism in modern economies. Recognizing that most legislators and regulators lack experience in the business arena, Phelps recommends that regulators intern in business enterprises and legislators self-educate themselves on how innovation works, thus hopefully reducing dependency on market distorting, inefficient subsidies and regulatory mandates for “targeted” industries. In the private sector, Phelps recommends reforms to discourage short-term perspectives by CEOs, mutual funds, and commercial banks, while encouraging long-term investments more valuable to shareowners, including efforts to encourage the establishment of new financial companies offering “relational” banking, which involves the development of personal financial service focused on the needs of the specific company. Phelps also argues that labor unions and professional associations impose restrictions on new entrants that often impede innovation, and that in order to address their political power they need to be active participants in the national dynamism debate. Lastly, in order to encourage youth to “refuel grassroots dynamism” in the American economy, “the main ideas of modern thought, including individualism and vitalism, need to be reintroduced in the economy.”

Like many economists, Phelps views “social responsibility” and “stakeholderism” as aims contrary to maximizing income for shareholders and employees. Managers, unlike academic economists, must be knowledgeable of the values and concerns of all relevant stakeholders to ensure *long-term* business success. In a real market economy, shareholders and employees are not the only stakeholders that impact the operations of the enterprise. Phelps’s thoughtful policy prescriptions are of interest and some are worth actively exploring, including educating legislators on the innovation process,

inviting business associations and unions into the dynamism debate, and encouraging long-term investment. Yet it should be remembered that institutional investors presently managing pensions are influencing company policies toward stable, longer-term investment prospects, and that there has been a growing trend to take public corporations private.

Phelps masterfully utilizes aggregate data on cross-comparative national economic productivity and adeptly complements it with international individual employee satisfaction survey results give the reader a rich empirical tapestry that support his theme. His focus on the philosophic underpinnings of the modern economy, even though he believes it is now restrained by corporatist ideology, is a clarion call to leaders of less-dynamic Western economies. Specifically, Phelps is spot-on in his indictment of the “new corporatism” in the American polity, which, from Obamacare to “green” energy subsidies, has become all too common. These policies have significantly contributed to the sick pallor cast over the U.S. market economy.

In conclusion, Edmund Phelps has written a convincing narrative of why modern economies have been the most successful economies in the 19th and 20th centuries, and why they need to regain their dynamism if they wish to continue into and throughout the 21st century.

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Falling Behind? Boom, Bust, and the Global Race for Scientific Talent

Michael Teitelbaum

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In Washington, doomsday prophets tend to be effective motivational speakers. They successfully persuade the electorate that their cause is worthy and prompt Congress to take action. In his book *Falling Behind? Boom, Bust, and the Global Race for Scientific Talent*, Michael Teitelbaum takes on a particular brand of doomsday prophet: those who see impending shortages in the science and engineering workforce. Teitelbaum walks his readers through five postwar cycles of boom and bust in the science and engineering