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## **The Justice of a Modern Economy**

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A country that supports a process of indigenous commercial innovation in the economy can expect to enjoy a wide spectrum of benefits – engaging jobs, exciting explorations and gratifying successes. My research into inter-country differences in household responses to surveys tends to confirm that.

I find that, instead of talking about "capitalist" economies, it is simpler to talk about what I call modern economies. By a modern economy I mean an economy that is good at creating new commercial ideas and good at *judging* which *creative* projects to back and which to reject. A modern economy is one with a high capacity and inclination to innovate – with a high level of *dynamism*. Historically, the early modern economies were the capitalist economies that arose in Britain in the early 19<sup>th</sup> century, in the United States a decade or two later and in Germany in the 1850s. With the development of company law, corporate finance, investment banking and patent law, the way was opened for a process of innovation: the conception of novel commercial ideas; the selection by financiers of some of these ideas for development, the realization by entrepreneurs of the envisioned products or methods, and the adoption or rejection by managers or consumers of some of the new products reaching the market. In this process, private ownership has been typical at every stage, required or not. But it appears possible for some not very capitalist economies to be pretty modern – witness Singapore and South Korea. And some once capitalist economies such as France and Italy became less modern – less capable of indigenous innovation – over the 20<sup>th</sup> century. (*Laissez-faire* – a *free market* of low taxes, tariffs and regulation – is *not* required to be modern; it may undermine capitalism's functioning.)

There have been over human history – and there still are – countries in which all the commercial innovations (in a broad sense of the term) are an application of inventions or discoveries made *outside* the economy; or they are an adoption and adaptation of innovations created by in *another* economy. Think of Holland in the 16<sup>th</sup> and 17<sup>th</sup> century or Scotland in the 18<sup>th</sup> century. That was Josef Schumpeter's early view of

how commercial ideas came to a country.<sup>1</sup> (His main message was that developing a new idea into a new product at an economical price required the skills of a savvy entrepreneur.) In modern economies, however, there are new ideas coming from *inside* the nation's economy: an original idea inspired by the observations and imagination of producers, employees, managers or consumers – people “on the spot.” This was the view of Friedrich Hayek.<sup>2</sup> It is the view of most experts today.<sup>3</sup> If innovation were mere Schumpeterian application or imitation, a socialist system could approximate the results of a capitalist system.<sup>4</sup>

*What are the distinctive benefits of a modern economy?* For many laymen, its main merits are the wealth accumulation it fosters and the “individual freedom” it helps to protect. Referring to capitalism in his Inaugural Address, President Obama said, “Its power to generate wealth and expand freedom is unmatched.”<sup>5</sup>

For me, making money does not begin to capture the value of a modern economy, such as a well-functioning capitalism. It may be that the challenge of making money, perhaps getting rich, in one's young or middle years is absorbing and fun: as Friedrich Nietzsche and Frank Knight suggested, trying to make a fortune is like participating in a sport. Yet social observers are right to question whether people find significant satisfaction *beyond some point* from increased *relative* wealth.<sup>6</sup> After you have *won the game*, what point is there in winning by a bigger *point spread*? Many entrepreneurs speak of the wealth received as a *by-product* of what they sought to achieve rather than the goal. In any case, what many people enjoy is an increase in their wealth relative to that of others, which means a *decrease* in some others' relative wealth. There is no reason for the government of a society to promote that sort of sport.

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<sup>1</sup> Schumpeter, *Theorie der wirtschaftlichen Entwicklung*, Leipzig: Duncker & Humblot, 1912.

<sup>2</sup> The earliest example is F. A. Hayek, *Collectivist Economic Planning*, London: Routledge, 1935. See also Hayek, “Competition as a Discovery Procedure [1968],” in Hayek, *New Studies in Philosophy, politics, Economics, and the History of Ideas*, Chicago: Univ. of Chicago Press 1978.

<sup>3</sup> It is the view of Alfred Chandler, Peter Drucker, Richard Nelson, Sidney Winter, Giovanni Dosi, Roman Frydman and Andrzej Rapaczynski, Virginia Postrel, Amar Bhidé and my view too.

<sup>4</sup> In the U.S. the greater part of medical progress comes from practice, not from science. See Richard Nelson, “How Medical Know-How Progresses”, Working Paper No. 23 of the Center on Capitalism and Society, 2008.

<sup>5</sup> Barack Obama, Inaugural Address, February 20, 2009.

<sup>6</sup> I am thinking of attitude surveys and commentaries by Bruno Frey, Richard Layard and Andrew Oswald, to name just those that immediately come to mind.

The value of *nationwide* advances in wealth may be on more solid ground. It *is* better to have more wealth in a city or nation where most others have more wealth too: possibilities of a richer and more rewarding life result. However, the relatively modern economies are *not* distinguished by relatively high wealth levels. The somewhat more socialist economies and more corporatist economies of continental western Europe have reached wealth levels far *exceeding* the levels in the more modern economies. Wealth per capita is higher in Luxembourg, Switzerland, Belgium, France and Germany than in the U.S., the U.K. and Canada – despite the high security offered by the continental welfare system.

The other driver of private wealth, namely, the level of productivity, is also equal if not greater in the former group of countries than in the latter group. A proposed explanation is that while those capitalist exemplars may be at or close to the “technical frontier,” thanks to their “lead” in cutting-edge innovation, they “waste” much of their output potential in false steps, in the costly processes of marketing, and an over-investment caused by the winner-take-all competition of costly R&D projects.<sup>7</sup> (But the top-down techno-nationalist projects that some relatively corporatist nations have substituted for discoveries bubbling up naturally from the business sector do not appear to have avoided waste.). One has to conclude that high wealth is not a characteristic attribute of modern economies, whether or it high wealth is a precious benefit. Corporatist economies are better at that.

As for freedom, it has been argued that a capitalist economy far more than a socialist or a corporatist economy offers helps to buttress people’s *personal* and *political* freedoms against the tyrannies of the state, communities and the culture. Owners of a firm in a capitalist economy would feel it in their pocket book if employees were hired or fired on the basis of their beliefs rather than the firm’s profits.<sup>8</sup> Yet the evidence is mixed: Some of the relatively socialist and corporatist economies of western Europe appear to be extraordinarily tolerant of deviance from the mainstream.

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<sup>7</sup> Historically, some corporatist economies have sought to substitute a top-down “scientism” for the discoveries bubbling up naturally from the business sector. Of course, the techno-nationalist projects undertaken in corporatist economies may produce some productivity gains. Yet the selection among these projects and the development decisions along the way are not immune to mis-steps. And techno-nationalism is prone to flaws of its own, such as a tendency to the grandiose and to over-engineering. So it is doubtful that industrial research policy can be credited for the good productivity levels exhibited in some corporatist economies.

<sup>8</sup> See for example Henry C. Wallich, *The Cost of Freedom*, New York, Harper, 1960. Somewhere Wallich wrote that “power is the great enemy of freedom.”

One benefit of a modern economy is the *economic* freedoms it provides entrepreneurs, managers, employees and consumers that socialist or corporatist systems do not provide.<sup>9</sup> Milton Friedman's work celebrates the "freedom to choose" as a *means to income*.<sup>10</sup> He suggests that incomes will be higher when participants are free to move over a wide range of regions, occupations and industries and when individuals and enterprises are free to collect micro data on which to make decisions. But that thesis brings us back to the claim that modern economies, owing to their freedoms, are better at producing income and wealth than more corporatist systems and socialist ones. As noted earlier, the best corporatist economies tend to exhibit comparable productivity and higher wealth.

The work of Friedrich Hayek from his *Road to Serfdom* onward suggests another kind of value in economic freedoms<sup>11</sup> In any real life economy (not theoretical models in which everything in the present and the future is known), actors may sense or conjecture opportunities or dangers about which there is little or no public knowledge while the individual has significant *private knowledge* about possible benefits or costs as well as *imagination* and *personal experience*. Individuals' freedoms *to act* (or not act) on their unique knowledge, intuition and judgment may be indispensable to people's sense of self-worth and self-reliance. In this view, it would be *inadequate* to gauge the value of freedom by its contribution to income, consumption, investment and even to the pragmatists' "expansion of talents" and "capabilities." The freedom to act on this basis – to take charge of one's own heading and make one's own mistakes – is a primary good in itself, one of huge importance. Is there evidence of greater economic freedoms in capitalist economies than in the more socialist or corporatist economies?<sup>12</sup> My research using survey data supports the widespread impression that, in the relatively capitalist economies, people in

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<sup>9</sup> Some of the public discussion here looks convoluted. It makes no sense to say that a merit of such a system is that it provides freedoms without which the system could not function. It is necessary to explain what the value to people of such freedoms might be.

<sup>10</sup> Milton Friedman, *Capitalism and Freedom*, Chicago: University of Chicago, 1962, and Milton & Rose Friedman, *Free to Choose*, New York, Harcourt, 1980.

<sup>11</sup> Hayek, *The Road to Serfdom*, London: Routledge, 1944. See also the commentary in Amartya Sen, "An Insight into the Purpose of Prosperity," *Financial Times*, September 20, 2004.

<sup>12</sup> Jeffrey D. Sachs says no in his "Response to Easterly on Hayek," *Greg Mankiw's Blog*, Monday, November 27, 2006. He notes that the Heritage Foundation/Wall Street Journal Index of Economic Freedom ranks Finland, Sweden and Denmark as 'free economies,' with Denmark ranked ahead of the United States – and this in spite of their high rates of taxation, which counts heavily in the Heritage index. This is undeniably interesting, since those three countries are widely regarded as pretty corporatist as well as somewhat socialist. However, the Heritage indicators of "freedom" largely differ from the individual freedoms in the workplace, financial markets, and product markets that I am clearly referring to.

ordinary jobs have freedoms that they value – more than workers in the relatively socialist or corporatist economies. In the former economies more than in the latter, workers say they want jobs offering chances to take initiative and responsibility, which reveals that they know such jobs are available, while acknowledging also the value of teamwork – thus the need both to give orders and take orders.<sup>13</sup>

It is important also to make explicit what Hayek must have believed but did not say. As a long line of Western humanists and philosophers propounded from Bergson, James and Hume on back to Cervantes, Cellini and Virgil, in a significantly unknown world, an individual's freedoms to experiment, to learn, to explore, to act on impulse, and to test ideas offer personal benefits in another category under the heading of *personal growth*: expansion of "talents" and "capabilities," widening experience and self-discovery. In my work I suppose that all or most people are capable of finding such satisfactions from taking part in the innovation process of a capitalist economy: examining untried ways of producing something, conceiving and developing an innovative product or method, and pioneering the adoption of a new product or method.<sup>14</sup>

In this view, the dynamism of a well-functioning capitalism has a fundamental merit. Ordinary people, if they are to find intellectual growth and an engaging life, have to look outside the home: they can only be found at work, if anywhere. And for these rewards to be available for large numbers of people, the economy has to be based predominantly on a well-functioning capitalist system. Thanks to the grassroots, bottom-up processes of innovation, it can deliver – far more broadly than Soviet communism, eastern European socialism, and western European corporatism can – chances for the mental stimulation, problem-solving, exploration and discovery required for a life of engagement and personal growth.<sup>15</sup>

*Can these benefits justify modern economy?* Could it be that a modern economy, in providing opportunities to act on their own knowledge, intuition and judgment and in providing opportunities to be engaged, to be challenged, to flourish and to be fulfilled, serve to *justify* such an economy? It is clear how that might be argued: *If a modern economy offers broad numbers in society chances for a life of initiative and discovery while the other systems deprive people of that experience,*

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<sup>13</sup> Phelps, "Economic Culture and Economic Performance: What Light is Shed on the Continent's Problem," 3<sup>rd</sup> Annual Conference of the Center on Capitalism and Society, Venice, July 2006.

<sup>14</sup> See my Prize Lecture, "Macroeconomics for a Modern Economy," Stockholm: Nobel Foundation, 2007, and papers of mine going back at least to 2003.

<sup>15</sup> My argument can be sampled in my paper for a 2003 Baumol conference and my June 2006 speech at Sciences-Po as well as the Venice paper and Prize Lecture cited above.

*then imposing the latter systems on society would be terribly unjust.*  
The answer would appear to be yes.

A plausible objection is that even a well-functioning capitalist system would not be just if it failed to strive for the largest possible *inclusion* of the productive population in that system. It can be accepted that such a system is not fully just, thus unjust. (I certainly agree.) But that does not imply that dynamism cannot be just until a just level of inclusion is sought and achieved. Moreover, it is not capitalism that stands in the way of inclusion; it is the inadequacy of wage subsidies.