Review of: "Liberalism Caused the Great Enrichment"

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This paper has an ambitious agenda based on providing a "take it all" explanation for the fundamental cause of economic enrichment in modern times, as opposed to fatalistic forecasts from the past. Innovation and technological changes are considered by the author as the main driver of development at Rich Countries in the World. According to author's theory, what economists love calling "fundamentals" is given by liberalism, which motivates discussing ideas, analyzing freely the pros and cons of issues and arrive to a better outcome relatively to a situation of constraints in the production of ideas and/or discussion. This general view is well-explained through many angles, and the author succeeds on designing an historically convincing picture of a sound relationship between liberalism and innovation.[1]

The author interestingly analyze different angles that cannot always be quantified by markets but play a crucial role in provoking innovation. In particular, he mentions that innovation is a function D (dignity), B (liBerty) and P (profit or prestige). Although I am an economist and I have been educated to write models, it is interesting for me to read a qualitative analysis mentioning the preponderance of these factors even when they are not always quantifiable. At the same time, we can learn a lot from models that succeed on picking the heart of the issue.

I shall mention that the discussion of innovation models has been increasing in Economics over the last fifty years. Deepening on the economic analysis on the different issues raised in the new models and citing the material written so far by modern theory may drive the economic discussion that appears in the paper one step further. I will start doing so through my comments, but I would like to clearly state that I have no intention of arriving to clear-cut and final conclusions on this deep issue. I am referring to the well-known discussion between "exogenous" and "endogenous" growth approaches, which picks in my opinion the economic forces described in the present paper.

The author cites Solow's model, which is the basic exogenous growth model. According to author's analysis, one drawback of this model is that growth is obtained exogenously and is related to exogenous increases in productivity that are closely related to technology – which in this model is exogenously given. In the modern "endogenous growth" theory[2], these processes are not exogenous anymore, and the discussion in Economic Policy at the world level is tilted toward what should be the right constraints – i.e., whether in the existing international equilibrium we should accept complete liberalism or should we agree on a set of constraints and coordination means that shall govern action at the world arena. A broad analysis of this issue would include discussing the architecture of International Organisms like the International Monetary Fund (IMF) and the World Bank. Before addressing this point, I would like to stress that while the author mentions that one huge problem is lack of market methodology to quantify unpaid compensations to important factors/activities, the issue of wealth/income distribution at the world level stands as a restraint for complete liberalism. By definition liberalism drives to a given income distribution, which modern governments and economists have been showing since a long time ago that is problematic. The best example I find in terms of current government policy is the increasing adoption and the increasing extent of the Earned Income Tax Credit Program at developed countries. This program is being adopted in many European Countries[3] and was implemented a long time ago in the US[4] (enhanced by both republicans and democrats), starting in the mid-70s; since then, its development is one-directional: EITC transfers increase as time evolves. This program is considered by economists as one that justifies re-distribution from high-income to low-income because it provides at the same time the right incentives;[5] in fact, the EITC is the modern testimony of economists' and governments' acceptance of a market failure – i.e., liberalism drives the economy to an income distribution that is extremely unbalanced – and this is the source of a market failure that needs correction through government intervention.

Let me start by speaking about the insights of the endogenous growth model theory as opposed to the exogenous growth model. The basic equation shown by the author is based on Solow's Production function:

And from this equation we obtain that productivity evolves exogenously according to the equation:

Where a is a parameter; i.e., total factor productivity is exogenously given and not explained by the model. Clearly the evolution of technology is behind this parameter.

In the context of the endogenous growth model, I am showing the analysis of Whelan (2014) who makes a parallel analysis in the context of the endogenous growth model. He arrives to the following equation:

Where the parameter λ, describes the extent to which diminishing marginal productivity sets in as we add researchers; φ represents the strength of the “standing on shoulders” effect, i.e., the more past inventions help to boost the rate of current inventions, the faster the growth rate will be; and n is the growth rate of the number of workers n. The higher this, the, faster the economy adds researchers. Whelan explains that his may seem like a somewhat unusual prediction, but it holds well if one takes a very long view of world economic history. While prior to the industrial revolution, growth rates of population and GDP per capita were very low, in the past 200 years we have seen both population growth and economic growth rates increase (he cites Clark, 2007, which provides a discussion of pre-Industrial revolution).

This analysis is showing that growth is explained by inventions and the evolution of technology, which according to the author is benefited by liberalism.

Grossman and Helpman (1994), based on findings of the endogenous growth theory, clearly mention that extreme liberalism is not an optimal solution. Their paper shows examples in which restrictions are needed for pursuing the right direction of progress. They mention two reasons: first, efficiency dictates marginal cost pricing, but innovation requires the existence of monopoly profits; second, efficiency demands that investment returns be fully appropriable, but the characteristics of knowledge suggest that spillovers will be prevalent. These two features require government intervention and coordination at the world level.

I would like to end my discussion by saying some words on what in my opinion should be an avenue for deepening our knowledge concerning market liberalism in Economics, in a world where countries are able to run protective policies. It is quite clear that the creation of institutions toward the end of World War II at the aftermath of the great recession – IMF and World Bank – improved resource allocation in the world, compared to the previous situation of complete liberalism at the world level. There is no doubt that countries confronted better the huge shocks of 2008 global financial crisis and COVID-19, compared to the crisis that took place before World War II. A huge question is whether there is enough coordination in the world concerning policies by different countries. While free capital flows ensure that capital can flow from developed to undeveloped economies, given the huge potential for growth in the latter group (enhancing innovation and technology adoption in these countries), my general feeling is that existing equilibrium is probably not at the right place. This is, in my opinion, a promising avenue for future research.

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[1] In the introduction of Knutsen (2020, page 2) it is possible to find the opposite argument.

[2]Razin (1972) presented a model based on the fundamentals of this theory in the seventies, and Romer (1990) is one of the pioneer papers of this strand of analysis. Helpman and Grossman (1994) provide a literature survey explaining both theoretical mechanisms and empirical findings.

[3] A description of European EITC initiatives is done by Laun (2019). The EITC was also adopted in Israel; see Brender and Strawczynski (2019).

[4] For a description of the system See Sholtz and Holtz (2000) and for an analysis of its advantages see Bastian and Michelmore (2018).

[5]As every single tool the EITC is not exempt from having drawbacks. Malul and Lusky (2009) show that low-income individuals may renounce to higher education because the EITC raises its alternative price, driving them to enter the labor market instead of investing in education.