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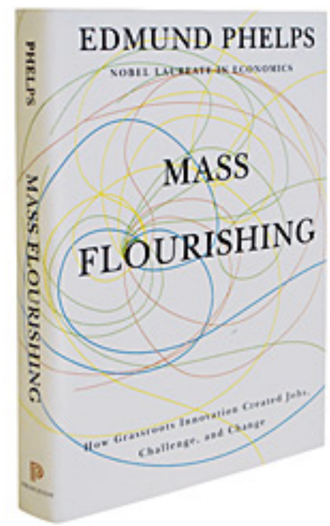
Business Literature: Books in Brief

The Rise and Fall of Western Innovation

A review of *Mass Flourishing: How Grassroots Innovation Created Jobs, Challenge, and Change*, by Edmund Phelps.

by Marc Levinson

Mass Flourishing: How Grassroots Innovation Created Jobs, Challenge, and Change
by Edmund Phelps, Princeton University Press, 2013



Mass Flourishing is meant to be Edmund Phelps's *chef d'oeuvre*, the capstone to a half century of research into the sources of national wealth. In it, the Nobel Prize–winning Columbia University economist lays out one Big Idea: Innovation is the key to economic growth, prosperity, and human happiness. Openness to innovation explains the Western world's sudden shift from stasis to growth starting in the 19th century, Phelps claims, and the United States' willingness to find new ways of doing things made it wealthier than any other nation. Now, though, a decline in the pace of innovation threatens prosperity, in the U.S. and everywhere else.

The main cause of this decline, according to Phelps, is corporatism—the inevitable tendency of businesses, workers, and other interests to band together to protect what they have. In modern economies, he says, corporations, unions, and other interests turn government into an agency for forestalling change and preserving the status quo. This problem has been worse in Europe than in the U.S., which is why productivity and per capita incomes in Europe have persistently lagged. But even in the U.S., he contends, "the waning of innovation was largely behind the increased joblessness and downward pressure on wages that have been endemic to the post-1972 period."

Having written a couple of books that highlight corporate efforts to hinder innovation, I'm sympathetic to this argument. Readers of the influential book *The Rise and Decline of Nations: Economic Growth, Stagflation, and Social Rigidities* (Yale University Press, 1982), by the late U.S. economist Mancur Olson, will find that Phelps is plowing familiar ground. But Phelps goes well beyond Olson in making specific historical claims about the ways in which declining innovation has crippled modern economies by dragging down productivity, reducing employment, and diminishing wealth. Unfortunately, he doesn't prove his case.

Part of the issue lies in how Phelps measures innovation. He constructed an indicator conceptually similar to Tobin's q, which compares the market value of a company's assets with their replacement cost. Arguing that a "country's stock markets offer a clue to the dynamism of its economy," Phelps takes the market capitalization of a nation's public companies, defined as the value of their shares plus outstanding bonds, and divides it by the output of the country's busi-nesses. The resulting market-cap-to-output ratio is, he says, "an indicator of how significant the prospective new ideas are in relation to the size of the economy."

Building on this idea, Phelps finds that countries with corporatist policies and practices, such as strong employment protections and coor-dination between employers and unions, have comparatively low stock market capitalizations. His explanation is that "corporatist elements slowed the inflow of new commercial ideas and that constriction of the inflow was a drag on the advance of productivity, which in turn imparted a drag on hiring, thus causing relatively low levels of employment as well." The U.S., then, with relatively weak labor laws, comes out looking far more innovative than most of Europe.

But it is not clear that Phelps's ratio measures anything beyond differences in national capital markets. For example, the capitalization of Germany's stock markets at the end of 2012 was 44 percent of the country's economic output, versus 119 percent in the United States. Does this really demonstrate that Ger-many is "devoid of indigenous innovation" (as Phelps says of Europe overall)? It may show nothing more than Germany's outsized reliance on privately owned companies that issue neither stock nor bonds. Indeed, the persistently strong export performance of Germany's precision manufacturers suggests customers are impressed by German innovation, even if Phelps is not.

Curiously, Phelps loses interest in his market-cap-to-output ratio when he evaluates the purported decline of innovation in the United States. Relative to U.S. economic output, the total value of shares listed on U.S. stock markets was more than twice as high at the end of 2012 as it was in 1988, according to the World Bank. This should, by Phelps's logic, mean that the U.S. economy has become more innovative over time. Instead, Phelps points to the slower U.S. productivity growth of recent decades as evidence of a lack of innovation.

But has there been a decline in innovation in the United States? By Phelps's own reckoning, competition spawns innovation, and I find plenty of evidence of increased competition in the United States since the 1970s. Global competition has forced U.S. manufacturers to shape up or give up. Deregulation has created competition in a dozen industries, such as natural gas production and telecommunications. And far fewer companies today enjoy the commanding market shares that General Motors, U.S. Steel, and your local newspaper boasted 40 years ago.

It is undeniable that the U.S. economy is not delivering the steadily improving wages and living standards the nation's residents expect. But *Mass Flourishing* fails to deliver convincing evidence that a lack of innovation is the culprit.

AUTHOR PROFILE:

Marc Levinson is an economist and author, most recently, of *The Great A&P and the Struggle for Small Business in America* (Hill & Wang, 2011). He was formerly the finance and economics editor of the *Economist*.