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Toward an Economics of the Slowdown in the West

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Toward an Economics of the Slowdown in the West

Edmund Phelps*

The West is in crisis – and so is economics. Economies are in a 50-year slowdown. Rates of return on investment have shrunk. Wages – and incomes generally – are stagnating for most people. Job satisfaction is down, especially among the young, and more working-age people are unwilling or unable to participate in the labor force. Many in France decided to give President Emmanuel Macron a try. Many Americans decided to give Donald Trump a try. And many in Britain looked to Brexit to brighten their lives.

Yet economists have been largely mute on the underlying causes of this crisis and what, if anything, can be done to restore economic vigor. It is safe to say that the causes are not well understood. And they will not be understood until economists finally engage in the task of reshaping how economics is taught and practiced. In particular, the profession needs three revolutions that it still resists.

The first concerns the continuing neglect of *incomplete knowledge*. In the interwar years, Frank Knight and John Maynard Keynes launched a radical addition to economic theory. Knight's 1921 book *Risk, Uncertainty, and Profit* argued that firms deciding whether to make an investment often have little sense of what profit it might bring – a condition later dubbed "Knightian uncertainty" in contrast to known risk. Keynes's 1921 book, *A Treatise on Probability* argued that many actions cannot be based on known probabilities.[1] What, then, *are* actions based on? Keynes, commenting in 1933 on America's worsening Depression, spoke of the importance of maintaining business

[1] See Frank H. Knight, *Risk, Uncertainty and Profit* (Boston: Houghton Mifflin, 1921) and John Maynard Keynes, *A Treatise on Probability* (London: Macmillan, 1921).

"confidence." And in his 1936 tome, *The General Theory of Employment, Interest, and Money* he says that the ups and downs of much investment are generated by "animal spirits."[2] But subsequent generations of economic theorists generally disregarded this breakthrough. To this day, despite some important work on formalizing Knight's and Keynes's insights (most notably by Roman Frydman and his colleagues), uncertainty – real uncertainty, not known variances – is not normally incorporated into our economic models.[3] (A much-discussed calculation by Robert Barro and Jason Furman, for example, made predictions of business investment resulting from Trump's corporate profits tax cut without bringing in Knightian uncertainty.)[4] The Uncertainty Revolution has still not succeeded.

Second, there is still a neglect of *imperfect information*. In what came to be known as the "Phelps volume," *Microeconomic Foundations of Employment and Inflation Theory*, we brought to light a phenomenon overlooked by economists.[5] Over-estimation by worker of wage rates outside their towns brings inflated wages and thus abnormally high unemployment; under-estimation brings bargain pay levels and thus abnormally low unemployment.

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[2] John Maynard Keynes, *The General Theory of Employment, Interest and Money* (London: Macmillan, 1936). For a recent discussion, see George Akerlof and Robert J. Shiller, *Animal Spirits: How Human Psychology Drives the Economy, and Why It Matters for Global Capitalism* (Princeton: Princeton University Press, 2010).

[3] See Roman Frydman and Michael Goldberg, *Beyond Mechanical Markets: Asset Price Swings, Risk, and the Role of the State* (Princeton: Princeton University Press, 2011); and *Imperfect Knowledge: Exchange Rates and Risk* (Princeton: Princeton University Press, 2007).

[4] Robert Barro and Jason Furman, "Macroeconomic Effect on the 2017 Tax Reform," Brookings Papers on Economic Activity, The Brookings Institute, Washington D.C. (March 2018).

[5] Phelps, *Microeconomic Foundations of Employment and Inflation Theory*, with A.A. Alchian, C. C. Holt, John P. Gould, Sidney G. Winter, Donald F. Gordon, Dale T. Mortensen, Allan Hynes, Donald A. Nichols, Robert E. Lucas, Paul J. Taubman, and Leonard A. Rapping (New York: W.W. Norton, 1970; London: Macmillan, 1971).

When workers lose their jobs in, say, Appalachia they have little idea – no well-based estimate – of what their wage would be outside their world and how long it might take to find a job; so they might remain unemployed for months or even years. There is a *deficiency of information*. (That differs from "asymmetric information.")

More than that, the volume sees every actor in the economy as being thrown back on whatever sense he or she can make of it, as Harold Pinter depicted in some early plays, and to do the best they can, as Voltaire urged in *Candide*. But theorists at the University of Chicago created a mechanical location model in which a person's unemployment is normally frictional and transitory – the so-called island model.[6] As a result, the Information Revolution has not yet been absorbed.

The last great challenge is the utter omission from economic theory of *economic dynamism*. While economists have come to recognize that the West has suffered a massive slowdown, most of them offer no explanation for it. Others, wedded to Schumpeter's early thesis on innovation in his classic 1912 book *The Theory of Economic Development*, infer that the torrent of discoveries by scientists and explorers has shrunk to a trickle in recent times.[7] Schumpeter's theory operated on the explicit premise that the mass of people in the economy lack inventiveness. (He famously remarked that he never met a businessman with any originality.)

This was an extraordinary premise. One can argue that the West as we know it – the modern world, we might say – began with the great scholar Pico della

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[6] Robert Lucas, "Expectations and the Neutrality of Money" *Journal of Economic Theory* 4, iss. 2 (April 1972): 103-124.

[7] Joseph Schumpeter *Theorie der Wirtschaftlichen Entwicklung* (Leipzig: Duncker & Humblot, 1912); trans. Redvers Opie, *The Theory of Economic Development* (Cambridge, MA: Harvard University Press, 1934).

Mirandola, who argued that all mankind possesses *creativity.* And the concerns of many other thinkers – the ambitiousness of Cellini, the individualism of Luther, the vitalism of Cervantes, and the personal growth of Montaigne – stirred people to *use* their creativity. Later, Hume stressed the need for imagination and Kierkegaard the acceptance of the unknown in. Nineteenth-century philosophers such as William James, Friedrich Nietzsche, and Henri Bergson embraced uncertainty and relished the *new*.

As they reached a critical mass, these values produced indigenous innovation throughout the labor force. The phenomenon of grassroots innovation by virtually all sorts of people working in all sorts of industries was first perceived by the American historian Walt Rostow in 1952 and described vividly and voluminously by the British historian Paul Johnson in 1991.[8] I discuss its origins in my 2013 book *Mass Flourishing*.[9]

So it was by no means clear that the Schumpeterian thesis would be incorporated into economic theory. But when MIT's Robert Solow introduced his growth model, it became standard to suppose that the "rate of technical progress," as he called it, was exogenous to the economy.[10] So the idea that people – even ordinary people working in all industries – possess the imagination to conceive of new goods and new methods was not considered. And it would have been dismissed had it been mooted. The Dynamism Revolution in economic theory was put on hold.

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[8] See Walt Rostow, *The Process of Economic Growth* (New York: Norton, 1952) and Paul Johnson, *The Birth of the Modern* (New York: Harper Collins, 1991).

[9] Phelps, *Mass Flourishing: How Grassroots Innovation Created Jobs, Challenge, and Change* (Princeton: Princeton University Press, 2013).

[10] Robert Solow, "A Contribution to the Theory of Economic Growth," *The Quarterly Journal of Economics* 70, iss. 1 (February 1956): 65-94.

With the great slowdown and a decline of job satisfaction, however, there now appears to be a chance to introduce dynamism into economic modeling. And doing so is imperative. The importance of understanding the newly stagnant economies has sparked an effort to incorporate imagination and creativity into macroeconomic models. I have been arguing for a decade or more that we cannot understand the symptoms observed in the Western nations until we have formulated and tested explicit hypotheses about the *sources*, or *origins*, of dynamism.

That theoretical advance will give us hope of explaining not only the slow growth of total factor productivity, but also the decline of job satisfaction. America cannot be America again, nor France be France again and Britain be Britain again, until their peoples are once again engaged in thinking of better ways to do things and excited at embarking on their voyages into the unknown.

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