MORAL CONSEQUENCES OF ECONOMIC GROWTH: THE JOHN R. COMMONS LECTURE, 2006*

by Benjamin M. Friedman**

I feel highly honored to receive this distinguished award from Omicron Delta Epsilon. I feel honored not only because of the fine record of Omicron Delta Epsilon, and the distinguished group of economists whom the society has recognized in this way in the past, but I am particularly pleased to receive an award in memory of John R. Commons, whom I consider a deeply sympathetic figure in several significant ways.

John R. Commons' interests ranged well beyond economics. One of his early books—published, incidently, by what was then called simply the Bureau of Economic Research (not yet the National Bureau)—was titled *Representative Democracy;* it was about the theory of government, and it offered detailed proposals for restructuring voting as well as other mechanics of how representative democracies should work. Another of Professor Commons' early books was *Social Reform and the Church;* in it he paralleled the interests and backgrounds of an earlier generation of scholars, the founders of the American Economic Association including such figures as John Bates Clark, Richard T. Ely and Simon Patten, all three of whom emerged out of America's Social Gospel tradition (a movement that, in a way that is little remarked on today, had a very important influence not just on the early days of the A.E.A. but on the development of economic thinking more generally in the latter decades of the nineteenth century).

John R. Commons also had his roots in a conception of economics as a form of natural science. He is best known today, of course, as the principal architect of what was then called "institutional economics," a branch of our discipline that is being revived today in the work, for example, of my Harvard colleague Andrei Shleifer as well as of Daron Acemoglu at MIT. The very first sentence of Professor Commons' 1934 textbook, *Institutional Economics*—a work of his mature years, published when he was 72 years of age—read, "This book is modeled upon textbooks in the natural sciences." But he immediately went on to make clear that the intellectual origins of his work were actually historical, and that they drew on the experience not just of the United States but of Europe as well: "Since I base my analysis on the Anglo-American common law, I begin with the English Revolution of 1689; then follows the World War of the French Revolution 1789"—an interesting way to describe the French Revolution—"then the American Revolution of 1861, an outcome of the suppressed European Revolution of 1848. . . ." (Commons was born during the Civil War, and like many of his generation he thought of the true American Revolution as the war that began in 1861, not the one that began in 1775). He went on to list what he called "the War of a Dozen Revolutions beginning in 1914," and then to refer to "the revolutionary cycle of which we [he meant the world of the of the 1920's and 30s] are now a part."

The principal focus of Professor Commons' work, however, was squarely on economics, and in particular the role of economic relations in a society. His work was not about atomistic agents making economic decisions in an individual capacity. His description of the field he helped to create emphasized that "Institutional economics . . . gives to collective action its proper place of deciding conflicts and maintaining order in a world of scarcity, private property and the resulting conflicts." He went on to say, "out of scarcity derives not only conflicts but the collective action that sets up order on account of mutual dependence." Political theorists would immediately recognize the central influence of such figures as Hobbes and Locke, and Americanists will likewise see the echo of Tocqueville. Economists today would, I hope, see the subsequent links to key figures in our own profession like Albert Hirschman.

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Finally, John R. Commons had a keen sense of the connections between positive economics and the realm of normative thinking that also encompasses our ethical and moral concerns. In one of his last essays, written even later than the textbook on *Institutional Economics,* and bearing the title "The Place of Economics in Social Philosophy," Commons wrote, "the three philosophies of economics, ethics and jurisprudence find themselves converging in these later days." And, he went on, "the various concerns . . . distinguishable as moral, economic and legal [are] also united in the larger concept of society."

It is precisely this "larger concept of society," as Professor Commons called it, and the place of economics in it, that I would like to address in my remarks this morning. Perhaps the easiest way to frame the question is to ask, what is the point of economics?—by which I mean, in particular, economics as a policy-oriented discipline aimed at least in part not just at describing but also at influencing (for the better, one hopes) the important and pervasive area of human activity that we study. Microeconomics is mostly about efficiency; this means keeping the production of goods and services as close as possible to the frontier of production possibilities at any given time. Macroeconomists study both business cycles and growth. In work on business cycles, the key issue is how to use policies, especially monetary and fiscal policies, to keep the economy as close as possible to the frontier of potential production and employment at any given time; economic growth, by its very definition, is about how to make that frontier expand over time. The question I would like to address this morning—and it is very much a question in which I think John R. Commons would have taken an interest—is why all this matters: Why should we care whether the economy's frontier of production possibilities expands, and whether at any given time actual production is close to whatever the frontier happens to be?

The very first thing to acknowledge in response is that if we lived under conditions that describe perhaps three-fourths of the world's population today, the answer would be immediate and obvious. Across a broad range of the of the current world distribution of incomes and living standards, higher levels of per capita output translate very immediately into improvements in the most basic human dimensions of life; when incomes are higher, people live longer, they suffer from fewer diseases, they are more likely to be literate, fewer of their children die in infancy, and fewer of their fellow citizens are undernourished. But these connections between increasing incomes and the basic necessaries of life have mostly played themselves out by the time a society reaches a standard of living equal to one-third, or perhaps 40 percent, of ours in the United States. For example, the Portuguese—Portugal represents the low end of the Euro-fifteen for this purpose—have a per capita income about half the level of ours; but the Portuguese live just as long as we do, their morbidity rates are no different than ours, their infant mortality (an American is embarrassed to say) is lower than ours, and they enjoy near 100 percent literacy just as we do. To take an Asian example, Korea today likewise has a per capita income equal to about half of ours; but the Koreans as well have life expectancy just as great as ours, and so forth.

For those of us who are blessed to live in a society where the average standard of living is far beyond anything our ancestors historically could have imagined, therefore, the question remains: Why should we, and why do we, care about rising incomes? Why does it matter that we keep our economy producing close to the existing frontier, and, moreover, work to expand the frontier over time?

The answer I would like to suggest reaches beyond the confines of economics narrowly construed: When a society is experiencing rising standards of living, broadly distributed across the population at large, that is precisely the circumstance under which it is likely also to make progress along a variety of dimensions that Western thinking has, at least since the eighteenth century, regarded not only as positive but as positive in explicitly moral terms.

What are these moral dimensions of society that, as I will argue, depend on whether people's living standard is improving? I have in mind, in the first instance, opportunity: the economy's ability, and also the society's willingness, to provide opportunities to those who are able and willing to take them up. Second, I have in mind tolerance; in an American context we would immediately think of race relations, as well as attitudes toward immigrants, and I also have in mind religious prejudice. Third, when the standard of living of the broad cross-section of the population is improving, I will argue, the society is likely to exhibit greater generosity toward those who, through some combination of natural circumstance, market forces and sheer luck, have been left behind. And fourth, when living standards are rising societies are also likely to move in the direction of strengthening their democratic political institutions, or, in countries where such institutions do not yet exist, toward establishing entirely new democracies. In all these ways, when a society is achieving material progress for the broad cross-section of its citizens, that is when it is also most able, and most likely, to make progress in these moral dimensions as well. Conversely, if a society is either stagnating or, worse yet, undergoing a decline in the material realm, it is likely not only to make no progress in these moral dimensions but, all too often, it enters a period of retreat and retrenchment.

The model of economic behavior that underlies this hypothesis rests on three elements: two for which we have ample empirical evidence, and a third that is simply an assumption. The first is habit formation. An enormous amount of evidence, for many countries, indicates that when people consider whether their standard of living is high or low they mostly do so not in absolute terms but in comparison to whatever they, or their families, have known in the past. Living better than one's "habit" is a source of satisfaction; living below it brings unhappiness. And second, a now-vast body of evidence indicates that people also gauge how well off they are by drawing comparisons to how they see people around them living. Living better than others makes people happier, while living below whatever community standard people accept (and the debate in this line of economic research is mostly about just who constitutes the relevant community) does the opposite. Both ideas, habit formation and the importance of relative incomes, have long been well known to economists. Adam Smith clearly stated each of them.

But if people evaluate their living standards on a relative basis, and use not one but two distinct benchmarks for comparison—so that their sense of well-being depends *both* on how they live compared to how they have lived in the past *and* on how they live compared to others around them—these two potential sources of satisfaction with one's life can be either complements or substitutes in the standard sense used in representing consumer demand. The third element of the model underlying the hypothesis I am suggesting (to repeat, simply an assumption) is that they are substitutes. Hence getting ahead by either benchmark strictly diminishes the urgency that people attach to getting ahead by the other one.

If everyone could somehow be made to live better than everyone else, therefore, people's concern to live better than they have lived in the past would be diminished; but of course that is impossible, except for presumably temporary situations of misperception. By contrast, not only is it possible for everyone to live better than in the past, that is precisely what economic growth means for this purpose. And, under the assumption that these two sources of satisfaction are substitutes, when this happens what is diminished is the importance that people attach to living better than everyone else. Hence resistance to movements that allow others to get ahead is softened, and aspirations for the public character of the society face less opposition. With only modest further elaboration, the hypothesis I have outlined follows.

What implications follow from this hypothesis if it is indeed true?

Four distinct implications are of primary importance. First, if the improvement of material standards of living for the majority of the population is the circumstance in which a society will make progress on these other moral fronts as well, then countries throughout the developing world—countries where incomes are far below ours—will not have to wait until they achieve Western living standards before they begin to liberalize socially and democratize politically. To cite again the example of Korea, at the time of the partition of the Korean Peninsula, more than a half-century ago, what is now South Korea was the poorer, more agricultural part of the of the country; most of the industry was located in the North. But over a period of roughly a quarter-century, beginning in the early 1960s, Korea achieved a remarkable record of economic growth that took the country's per capita income from an extremely low level to roughly one-third of the American standard. And, over approximately a quarter-century lagging somewhat behind this period of strong economic growth, Korea evolved from what had been a one-party military dictatorship into a well functioning electoral democracy with broad civil liberties and political rights—which is what the country is today.

To take another example, perhaps even more important for the evolution of world affairs today, what about China? Over the past quarter-century the Chinese have maintained the world's highest rate of economic growth, roughly 7 percent per annum in real per capita terms. If the hypothesis I am suggesting is correct, and if the Chinese are able to continue to improve their living standards as they have been doing, then within our lifetimes I would expect to see the country moving significantly further in a direction that would be characterized as liberal and democratic (even though what ensues may not look exactly like America's form of electoral democracy).

If this conclusion seems optimistic, that is because it is. The line of intellectual development from which the hypothesis I am suggesting emerges is the Enlightenment tradition of the eighteenth century, which from its very origins has been grounded in, and drawn strength from, a robustly optimistic perspective on the human enterprise. I see no reason why economics, which is also an outgrowth of Enlightenment thinking, should not once again embody that same fundamental optimism today.

The second implication of my hypothesis, however, is more sobering. If conditions under which the broad cross-section of a society's population have a sense of getting ahead economically constitute the circumstance under which the society also moves forward in the political, social, and ultimately moral dimensions I have mentioned, then no society—no matter how rich it becomes or how-well formed its institutions may be—is immune from seeing its basic values at risk whenever the majority of its citizens lose their sense of forward economic progress. This is an especially sobering thought for Americans today because 2004 was the fifth consecutive year in which the median income in the United States failed to keep pace with inflation. (Data yet for 2005 are not yet available.) Total U.S. production is expanding nicely; over these same five years, real U.S. GDP advanced on average at 2.6 percent per annum. But the fruits of that increased production have been sufficiently skewed that more than half of all Americans nonetheless saw their real incomes decline.

Five years is not a long time from the perspective of the hypothesis I am advancing, but it is hardly a trivial span either. I picture people continually asking themselves questions, of a distinctly intergenerational character, that vary according to their respective stage of the life cycle: Young adults just entering the work force ask, how is my career starting out, compared to what my aunts and uncles saw in their day? Later on, people ask, what is it like living in my house, compared to what I remember about growing up in my parents' house? Further along, people ask, how am I providing for my children, compared to how my parents provided for me? And how is my career trajectory developing, compared to what my father experienced? And, for more mature adults, what are the prospects for my children's careers, compared to what I knew as a young man or young woman myself? Given the current stagnation of the median income in the United States, there is cause for serious concern that if we continue along our current trajectory many of the pathologies that we have seen in the past, in periods of economic stagnation both here and in other countries, will once again emerge.

What specific kinds of pathologies might we expect under such circumstances? To take an example that is always at or near the forefront in American thinking, as well befits a nation constructed from immigration, attitudes toward immigrants are a useful case in point: Why did the United States experience the wave of anti-immigrant violence that afflicted the country in the 1850s? Why did that violence largely disappear after the Civil War? Why was there then, in the1880s and 1890s, a return not of violence but of extremely ugly anti-immigrant agitation? Why did that movement then give way, after the turn of the twentieth century, to a period in which the mood of the country swung toward welcoming—and, to use the vocabulary of the time, "Americanizing"—large numbers of new immigrants? (In the early years of the twentieth century, the Fourth of July was regularly called "Americanization Day," and it became commonplace for Americans—typically not native-born white Protestants—to claim, mostly falsely, that they had been born on that date. A more practically significant consequence was the high school movement. As late as 1890 only 3 percent of Americans had graduated from high school. But if the country was going to welcome immigrants in large numbers, and also "Americanize" them, there had to be some vehicle for achieving this objective. For the same reason, this is also the period when the "social studies" curriculum first became a central part of American education.)

Why, then, did this welcoming mode in American society give way, in the 1920s, to what became the most restrictive and also the most discriminatory immigration laws the United States has ever seen, including especially the aptly named National Origins Act of 1924? Why did that period of discrimination and exclusion then give way, after World War II, to a complete reform of immigration? Why did that more welcoming approach to immigrants then generate a backlash in the 1980s and early 1990s, with such manifestations as Proposition 187 in California and the movement in states like Florida and Texas to deny certain benefits even to legal immigrants? Why did that resistance then give way, in the late 1990s, to a situation in which the one candidate who chose to run for president in 2000 on an explicitly anti-immigrant platform (Pat Buchanan) attracted so few votes in the Republican primaries that he had to change parties? And why now, a half-a-dozen years later, do we once again see a renewed interest in proposals for restrictive immigration legislation in the Congress?

It would be foolish to pretend that every twist in this 150 years of American attitudes toward immigrants was driven, in a tightly deterministic way, by the ebb and flow of economic prosperity and stagnation. But it would be even more foolish to pretend that the underlying economics had nothing to do with it. When we look also at other dimensions of American society like race relations, or generosity to the poor, or religious prejudice, or even the most basic elements of our democratic institutions—even such fundamentals as when blacks got the vote; or when women got the vote; or when blacks *actually* got the vote (there was a 95-year delay between the *de jure* event and the *de facto* realization)—it would likewise be foolish to pretend that the underlying causation stems entirely from a changing economic situation, but even more so to conclude that economic conditions were irrelevant. As we now enter what may well become the seventh consecutive year of declining incomes for the majority of America's citizens, this is indeed a sobering thought.

The third implication of the hypothesis I am suggesting applies to public policy. One frequently hears the view that the best stance of public policy with respect to matters like economic growth is simply to let the market mechanism determine outcomes: Let families decide how much they want to save, let firms decide how much they want to invest, and then, through the marvelous process that professors of economics take delight in explaining to introductory students year after year, the interaction of the two will establish an economic growth rate. *And*—so the story goes—because this is the market-determined rate of growth, it is therefore the optimal rate. By contrast, a sharp implication of the hypothesis I am advancing is that the optimal economic growth rate for a society is faster than what the market mechanism, left to its own devices, would deliver.

The reasoning here is analogous to why the unimpeded market mechanism over-produces pollution, and noise, and congestion. These are externalities. There is no reason, for example, that the individual driver would take into his or her own internal calculus the cost inflicted on other people by a car's emissions, and therefore—as an individual matter—choose to spend roughly $1,000 to install a catalytic converter on the car's tailpipe. In this situation the role of public policy is to induce exactly this form of action as a collective matter. Similarly, the hypothesis that I have outlined suggests that economic growth also delivers externalities—externalities in the form of fairness, tolerance, democracy, and opportunity. These are externalities because there is no market where we trade tolerance; there is no place where one can buy a option on democracy; there is no explicit buy/sell price placed on expanded opportunity. As a result, families deciding how much to save and businesses deciding how much to invest have no reason to take into their internal calculus these aggregate-level consequences of their actions, consequences which we value not in market terms but in moral terms.

The straightforward conclusion that follows is that there is a positive role for public policy in promoting economic growth, beyond what the market mechanism would deliver on its own. It is also worth pointing out explicitly, however, that for purposes of this argument the *form* of that economic policy is also crucial. If part of the reason we value economic growth, and the reason we favor public policies that will spur economic growth beyond purely market-determined rates, is that we seek a fairer society with more opportunity and greater democracy, then it clearly makes no sense to pursue economic growth through policies that themselves undermine fairness and opportunity, or tolerance and democracy. Fortunately, at least for a country like the United States, there is no lack of policies that, if implemented, would simultaneously spur our rate of economic growth and make for a fairer, more democratic society. Seeking economic growth as the source of positive externalities, and hence pursuing economic growth through policies that at the very least are congruent with the characteristics of society that we treat as positive externalities—and that in many cases reinforce them—therefore has not just conceptual but also practical force.

The final implication I will draw from my hypothesis is the broadest of all. If an improving material standard of living, for a broad cross-section of the population, renders a society more likely to achieve progress also in these political, social and moral dimensions, then I believe that we need to change the character of our public conversation about economic growth. We of course value economic growth for the material benefits that it brings; this is, after all, the very definition of economic growth. At the same time, in recent decades we have become increasingly aware of drawbacks associated with the economic growth process—most obviously environmental degradation, but others as well—that we also have come to regard in moral terms. As a result, our typical conversation today about economic growth is one in which people frame the debate as a weighing of wholly material benefits against wholly moral drawbacks. Many people further conclude that their sense of themselves—am I a person who mostly emphasizes material concerns? or am I more interested in moral values?—therefore translates into whether they are supposed to be in favor of economic growth or against. Someone who cares more about material concerns believes that he or she should be for economic growth, while someone who places greater emphasis on the moral dimensions of life instead is led to conclude that he or she should resist economic growth, and should oppose policies likely to spur that growth.

By contrast, the hypothesis I am suggesting is that economic growth brings benefits in the form of opportunity, tolerance, democracy and fairness—characteristics of a society that ever since the eighteenth century we have valued explicitly in moral terms. It is wrong, therefore, to structure the debate over economic growth as one of balancing purely material benefits versus purely moral drawbacks. The benefits are, importantly, moral as well. Similarly, the mapping of a person's location on the spectrum from material concerns to moral concerns into his or her indicated stance in either favoring or resisting economic growth, and hence either supporting or opposing growth-related policies, is a false mapping.

If there is a positive contribution to be made by this line of thought, it is precisely in the form of helping to change the character of our public conversation in a way that, over time, not only will enable us to get the matter right—which, in itself, is surely valuable—but also will lead us to adopt genuinely growth-enhancing policies. I think this is an objective John R. Commons would have endorsed in his day, and that we should welcome in ours as well.