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Simple Sophisticated Effective

Perspective

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In This Issue . . .

- Forensic science helps solve *who-dun-it?* mysteries.
- Fresh inquiries into history represent forensic files of sorts for economics.
- The ultimate economics *what-dun-it?* mystery: why did growth take off 250 years ago?
- Economic freedom, new respect for individuals, and supporting institutions and culture unleashed ingenuity unlike any previous time.
- "Innovationism" emerged.
- Standard of living lifted higher by rising compensation *and* increased availability of affordable goods and services.
- Mass flourishing continues.
- Why Great Powers lose their mojo.
- Special interests wish to preserve status quo.
- Helicopter governments attempt to de-risk economic life.
- Appendix: What happened in Japan and Europe.

What-dun-it?

Enjoy "*who-dun-it?*" mysteries? If so you have good company. Two of the longer running TV shows, *CSI: Crime Scene Investigation* and *Forensic Files* are who-dun-its. Adding to these shows' intrigues are the fascinating forensic detection techniques that are used to uncover evidence crucial in solving the presented cases.

If only investors had similar forensic tools that could shine the light on economics! Instead, confusion reigns far and wide.

Are we stuck in a *secular stagnation* due to insufficient demand as some influential economists tell us? Is their prescription for economic "pump priming" of still more government borrowing to fuel infrastructure spending the answer? Have all the important things already been invented as some claim? Are the negative-interest-rate experiments underway overseas the ticket out of slow growth lane?

Journalist Joe Klein wrote that our "nation of dodos" is "too dumb to thrive," and Thomas Friedman repeatedly points to Chinese authoritarianism as a model of efficient policymaking for the new century.

—Glenn Hubbard and Tim Kane

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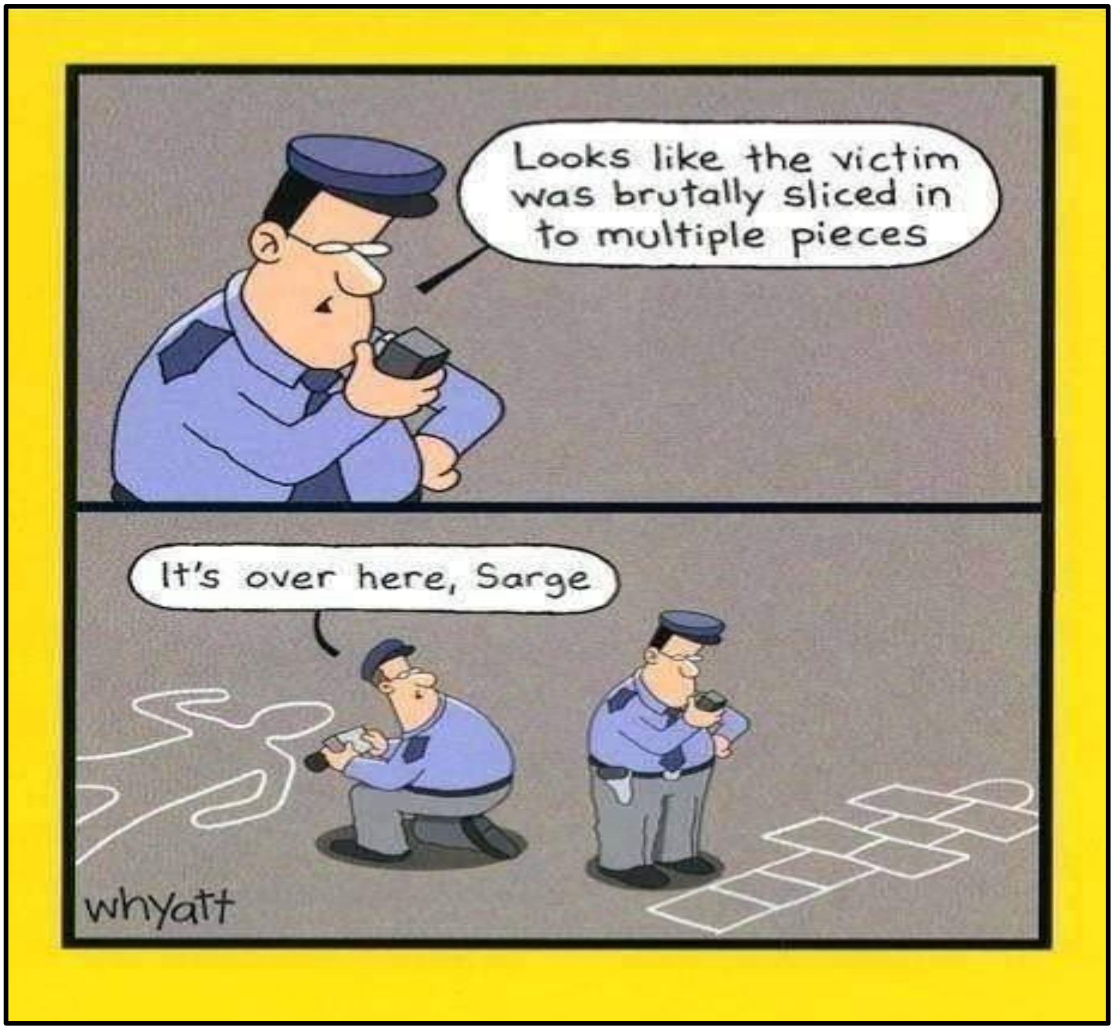
Other voices question whether economic growth is all that important and desirable in the first place. Are they right? Is Chinese authoritarianism the new model of efficient economic policymaking as some popular pundits claim?

In recent years several important investigations of economic history have arrived on the scene. Collectively, these examinations represent forensic files of sorts as they address fundamental economic issues such as; why economies grow and why they don't.



We have discussed some of this research on prior occasions. But against the backdrop of prevailing economic confusion, a review of the insights that can be gleaned from ***the most amazing, and yet under-told, stories in economics*** seems warranted.

Innovationism

Books by economic historians, McCloskey, Phelps, Hubbard/Kane and Mokyr[1] essentially ask the ultimate "*what-dun-it*?" question in economics. Why did growth in economic well-being (i.e. living standards), which made little progress for *eons*; suddenly take off like a rocket roughly 250 years ago? (See Figure 1 on the following page).

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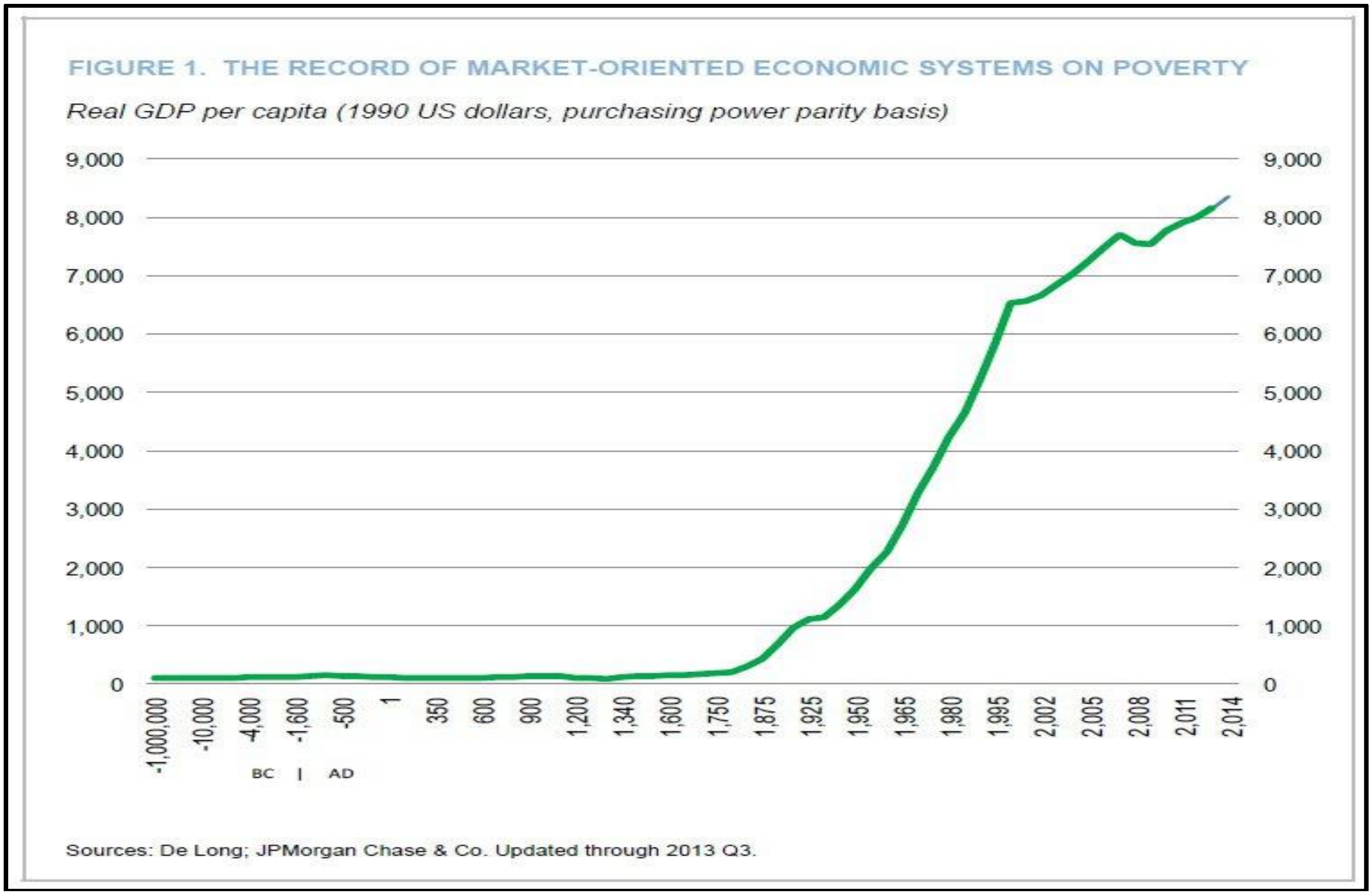
[1] Deirdre N. McCloskey, *Bourgeois Dignity: Why Economics Can't Explain the Modern World*, University of Chicago Press
Edmund Phelps, *Mass Flourishing: How Grassroots Innovation Created Jobs, Challenge, and Change*, Princeton University Press
Glenn Hubbard and Tim Kane, *Balance: The Economics of Great Powers from Ancient Rome to Modern America*, Simon&Schuster
Joel Mokyr, *The Lever of Riches: Technological Creativity and Economic Progress*, Oxford University Press



Granted, unlike crime scene forensic science where only a trace of DNA can solve a mystery, *causal* factors in economics are much messier to discern. This is particularly true when the economy is such a dynamic and adaptive system as has been the case over the past 250 years.

It is likely that a constellation of factors is the answer to this economic *what-dun-it?*. The aforementioned researchers' conclusions narrow the factor field considerably:

- The growth in living standards *cannot* be accounted for by increases in measured physical inputs like capital and labor only. Instead, other "things" triggered the growth.
- Chief among these other factors were: property rights, rule of law, an independent judiciary, and *cultural values* that emphasized economic freedom and granted dignity to ordinary citizens engaged in commerce. This confluence of factors unleashed human ingenuity in the search of solutions to problems in everyday life unlike any previous period in time.

> ***"Nations unaware of how their prosperity is generated may take steps that cost them much of their prosperity."***
>
> **Nobel Laureate Ned Phelps**

- The unleashed ingenuity ushered in furious innovation that drove productivity advances across wide swaths of the economy. One didn't need to be from nobility, be a straight-A student, or be anointed by the upper crust to innovate. McCloskey suggests that the term *innovationism* is much more descriptive of the underlying economic forces at work than is the term *capitalism*.

- Interestingly, while science played an important role in much innovation, often scientific understanding of why something worked only came *after* innovation. Examples include the steam engine/thermodynamics, and the Wright Brothers/aerospace.

- Innovationism occurred in countries with "institutions" (government) that were generally supportive despite the threat to the status quo that it typically creates.

- The standard of living was lifted dramatically via a "*double play process*".

  First, wages moved higher along with productivity growth.

  Second, innovation made available to most everyone new and affordable goods and services on an unprecedented scale. To paraphrase Warren Buffett; ordinary Americans could live better than John D. Rockefeller—the "richest" person in history—ever did.

  In case one thinks the *double play process* was limited to a time long since passed, consider the following.[2]

  ✓ The percentage of an average household's budget devoted to food declined from nearly 50% in the early 1900s to a little over 10% in recent years, according to the Bureau of Labor Statistics. If that percentage had not declined the average household today would spend more than $2,000 *a month* on food.

> ***"The expanding ideology of liberty and dignity has inspired proliferating betterment by and for the common people."***
>
> **Deirdre McCloskey**

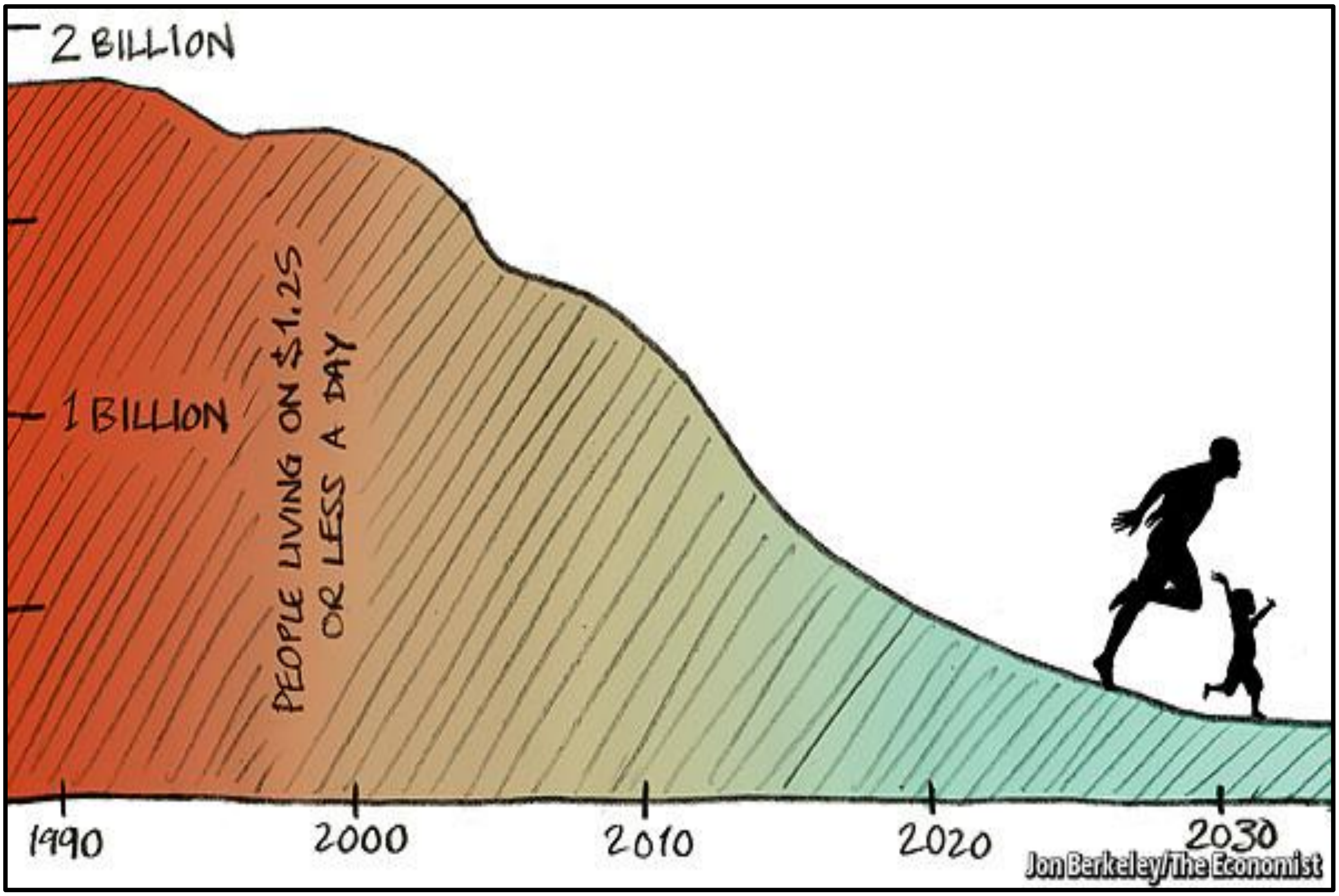
  ✓ In 1930 Americans spent more than 8% of their disposable income on energy, according to the Bureau of Economic Analysis. During the 1980s oil spike it peaked at almost 10%. Today it's less than 4%, an all-time low. The decline in energy spending as a share of income since 1950 means the average household can spend over $1,700 on other goods and services each year that used to go toward energy.

[2] The check-marked points are from Morgan Housel, *What a time to be alive*, tumblr.com

- ✓ While pundits repeat the chant that middle class wages have not grown much since Reagan was first elected President, median *compensation*—which includes things like health insurance subsidies and company 401(k) matches—is up significantly in inflation-adjusted terms since 1980. People are getting raises, but part of the increases is coming in the form of non-wage benefits.

This period of *mass flourishing* or *constant betterment* as Phelps and McCloskey respectively call it, hardly represents the exploitation of workers that Karl Marx feared. And as Figure 2 below suggests, as economic freedom and the fruits of innovationism have gone global, billions are being lifted from abject poverty.

Figure 2: Great news that gets remarkably little press coverage



In sum, *what-dun-it?*

Edmund Phelps summarizes it well; *"Prosperity on a national scale—mass flourishing— comes from broad involvement of free people in the processes of innovation: the conception, development, and spread of new methods and products—indigenous innovation down to the grassroots. This dynamism may be narrowed or weakened by institutions arising from imperfect understanding or competing objectives. But institutions alone cannot create it. Broad dynamism must be fueled by the right values and not too diluted by other values."*[3]

[3] Edmund Phelps, <u>*Mass Flourishing: How Grassroots Innovation Created Jobs, Challenge, and Change*</u> , Princeton University Press

Is economic growth important? If the economy grows at 2 percent, it will double in about 36 years. If it grows at 3 percent, it will double in 24 years. Tax revenues are a function of economic growth. A double for the U.S. economy would potentially go a long way towards defusing many of the long-run fiscal imbalances the country faces.

Why Great Powers lose their Mojo

Phelps noted the importance of "culture" and "values" as support mechanisms for innovationism. Hubbard and Kane's book, Balance: The Economics of Great Powers from Ancient Rome to Modern America, noted earlier, offers some additional perspective on this important but overlooked topic.

Their study of history makes the compelling argument that the decline in the "Great Powers" that has existed has been fundamentally economic in nature. Hubbard and Kane note; *"They lose their leadership role when they stop pushing innovation at the technological frontier"*.

"The economic decline is the consequence of stagnant institutions, primarily a political system biased into status quo inaction." When the political system (government) inhibits innovationism, not surprisingly, you get less of it.

Why might Governments become "Biased into Inaction"?

First, innovationism brings *creative destruction* forces to bear on economies. The new creative innovation disrupts the status quo. Some are economically hurt by the change. Most adapt but some never recover.

The *destruction* side of the *creative/destruction* process is often readily apparent. The disrupted and those threatened by potential change often seek to inhibit it by political means. It was easy to see the shuttered buggy whip factory for example. The benefits of the *creative* side of the equation, however, are only apparent over time.

The second reason countries may become hostile to innovationism may best be described by the term, *helicopter government*. We've all heard about (or witnessed firsthand) helicopter parents. Hubbard and Kane explain the same thing can happen within an economy and a country's culture.

They note; *"In the same ways new parents become sensitive to risks to their child, this protective instinct is mirrored in the way we collectively ponder our wealth and economic status."*

"However, overprotective parents can also stunt the development of their children, making them less aware of the world outside, less creative, and less confident than their peers. Risk aversion can be unhealthy."

Many would agree that a safety net of government assistance is appropriate to help those "down on their luck". However, just as it's a slippery slope between judicious parenting and helicopter parents, so it is for government's intervention in the economy.

Like the Great Depression before it, the Financial Panic of 2008 impacted the nation's psyche. Fearing a repeat coupled with a "never again" desire of the helicopter government, risk aversion has become pervasive.

Wide sweeping regulations have exploded since 2008 and likely reinforced the risk-aversion mentality and stunted innovationism. An excellent review of the situation can be found in recent Congressional testimony of economist John Cochrane[4]. (It is several paragraphs long—*below and the following page*—but a quick and incisive read.)

"Regulation is strangling business investment, and especially the formation of new businesses. But the main problem with regulation is how it's done, not how much. If we fix regulation, the quantity will take care of itself.

Regulation is too discretionary—you can't read the rules and know what to do, you have to ask for permission granted on regulators' whim. No wonder that the revolving door revolves faster and faster, oiled by more and more money.

Regulatory decisions take forever. Just deciding on the Keystone Pipeline or California's high speed train—I pick examples from left and right on purpose—takes longer than it did to build the transcontinental railroad in the 1860s by hand.

[4] Growing Risks to the Budget and the Economy, Testimony of John H. Cochrane before the House Committee on Budget, September 14, 2016

Regulation has lost rule-of-law protections. You often can't see the evidence, challenge witnesses, or appeal. The agency is cop, prosecutor, judge, jury and executioner all rolled in to one. (And, a Congressman pointed out during the discussion, recipient of collected fines.)

Most dangerous of all, regulation and associated legal action are becoming more politicized. Each week brings a new scandal. Last week, we learned how the Government shut down ITT tech, but not the well-connected Laureate International. The IRS still targets conservative groups. The week before, we learned how the company that makes Epi-pens, headed by the daughter of a Senator, got the FDA to block its competitors, Congress to mandate its products, and jacked up the price of an item that costs a few bucks to $600. This is a bi-partisan danger.

America works because you can lose an election, support an unpopular cause, speak out against a policy you disagree with, and this will not bring down the attentions of the IRS, the EPA, the NLRB, the SEC, the CFPB, the DOJ, the FDA, the FTC, the Department of Education, and so forth, who can swiftly put you out of business even if eventually you are proven innocent, or just slow-roll your requests for permissions until you run out of money.

Insist on strict timelines—if an agency takes more than a year to rule on a request, it's granted. (I later learned that this is called a "shot check" in Washington, a nice metaphor).

This freedom does not exist in much of the world. The Administrative state is an excellent tool for cementing power. But when people can't afford to lose an election, countries come unglued. Do not let this happen in the U.S.

Congress can take back its control of the regulatory process. Write no more thousand-page bills with vague authorizations. Fight back hard when agencies exceed their authorization. Insist on objective and retrospective cost benefit analysis. Put in rule-of-law protections, including discovery of how agencies make decisions.

Health care and finance are the two biggest new regulatory headaches. The ACA and Dodd-Frank aren't working and, more importantly, are drags on employment and economic growth. Simple workable alternatives exist. Implement them.

The real health care problem is not how we pay for health care, but the many restrictions on its supply and competition. If hospitals were as competitive as airlines, they would work darn hard to heal us at much lower—and disclosed!—prices.

Competition is always the best disinfectant, guarantor of good service and low prices. Yet almost all uncompetitive markets in the U.S. are uncompetitive because some law or regulation keeps competitors out."

Today’s Investment Outlook

Pervasive risk aversion and helicopter governing have, in our estimation, thrown sand in the gears of innovationism. Economic growth is slower than it could be.

Perhaps the election will usher in an era where helicopter government policy assumes a “lighter touch” when it comes to intervention in the economy. Perhaps not.

Whatever the outcome, the forensic files of economic history strongly suggest the pessimists are likely wrong, however. Innovationism may be inhibited, but it is not moribund. Recall Hubbard/Kane’s observation: ***“Great Powers lose their leadership role when they stop pushing innovation at the technological frontier”.***

Cloud computing, software as a service, internet of things, 3-D printing, software simulation, AI, material sciences, biotech drugs, nanotech, quantum computing, an unprecedented ability to tap into knowledge networks, collaborate and mingle ideas are not just pushing at the technological frontier but likely *extending* it to new levels.

Discovering new solutions to human problems takes lots of trial and error experiments. Every day legions of people apply themselves towards making a better life as part of the *what-dun-it?* process. They have incredibly powerful tools to pair with ingenuity to solve problems—the ingredients for *what-dun-it?* remain in place.

Innovations are hardly ever obvious before the fact. For if they were, the innovative solution would have already been discovered. The future is always hard, problems always exist. But with problems come potential solutions…and within those solutions are investment opportunities.

> ***If prosperity is created by solving human problems, a key question for society is what kind of economic system will solve the most problems for the most people most quickly. This is the genius of capitalism (innovationism): it is an unmatched evolutionary system for finding solutions.***
>
> **Eric Beinhocker, Nick Hanauer,**
> ***Redefining Capitalism*, McKinsey, 2014**

Appendix: Japan and Europe, who-dun-it?

In their book, *Balance: The Economics of Great Powers from Ancient Rome to Modern America*, Hubbard and Kane also offer some interesting insight about the Japanese and European economies.

They suggest that countries that did not previously participate in innovationism have available *catch up* growth options.

As they put it: *"Because ideas flow freely, any economy should in theory be able to adopt existing technologies without paying for their initial discovery. The assembly line. The limited liability corporation. The law of supply and demand. It's all free. Any economy can adopt these freely and should then converge to the per capita income frontier of those that did the initial discovery".*

Take the auto industry as an example. In the late 1960s U.S. manufacturers had dominate market share but knowledge of car manufacturing at that point was relatively easy to acquire.

Japan was able to build strong auto manufacturers and took significant market share when consumer dissatisfaction with U.S.-built cars emerged beginning in the 1970s.

However, it is critical to distinguish between *catch-up growth* and *entrepreneurial innovationism.* An economy that relies primarily upon catch-up growth will ultimately "hit the wall" in terms of the pace of growth.

Hubbard and Kane argue that is indeed what's occurred within the Japanese economy. They note: "The Japanese catch-up economic model relied on coercive and centralized (government) management of industry, export manipulation, and heavy infrastructure investments. The large Japanese firms that emerged excelled in *marginal innovation* through research and development.

The downside of corporate gigantism has been a paucity of entrepreneurship. Japan had plenty of small businesses, but they tended to be restaurants and retail establishments, not the kind of start-ups that develop and deploy technological innovations. The feature of pioneering innovation in America was generally lacking in the Japanese supermodel."

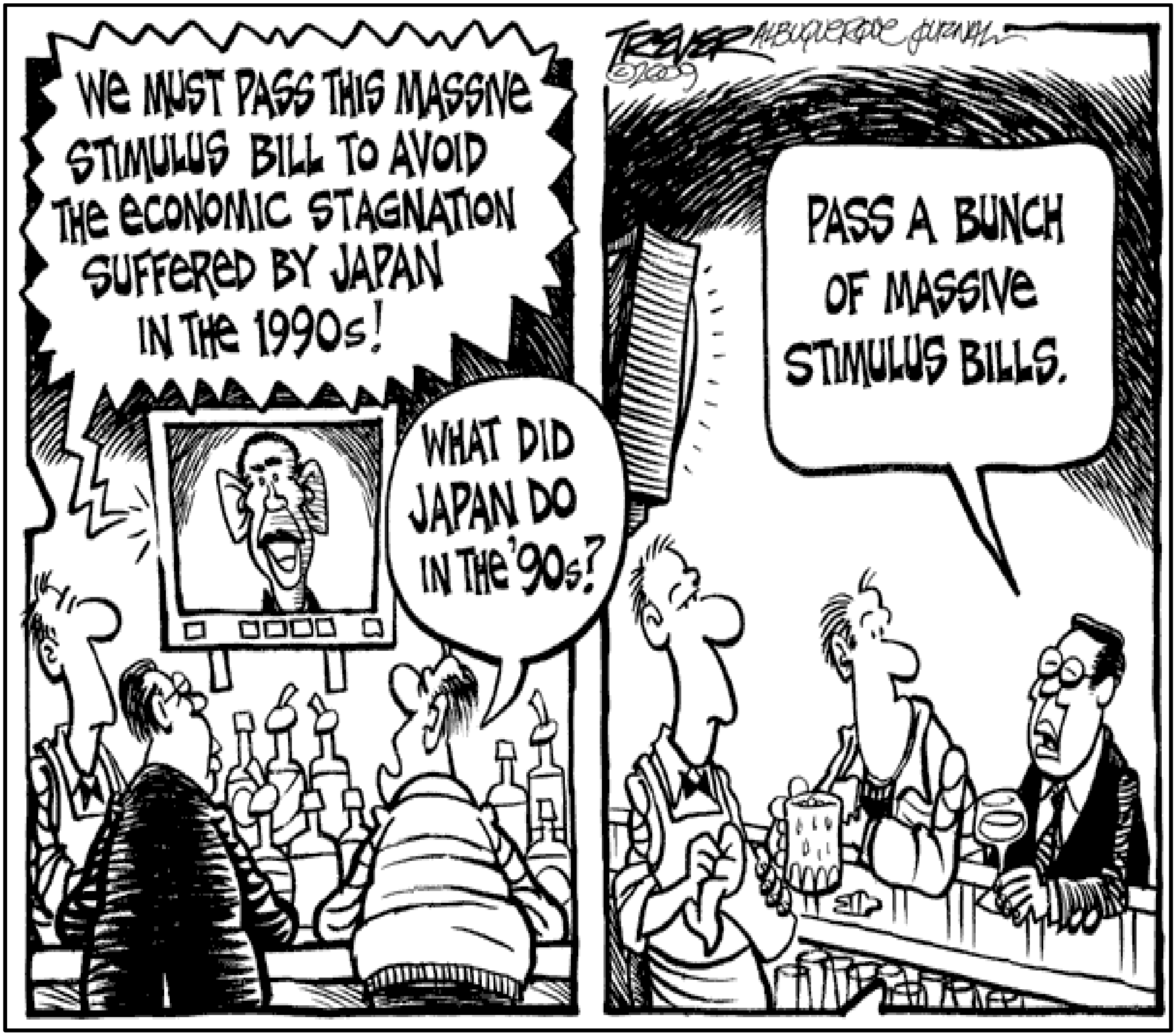
Why was pioneering innovation lacking? Hubbard and Kane point out the existence of a strong aversion to disruption of the existing status quo order within the Japanese culture. Deviation and non-conformism are not encouraged. Such an environment is not favorable to technological progress.

For similar reasons they warn; *"The ceiling hit by Japan will soon be hit by Korea and will be hit by China in the next two decades, though in each case at different velocities."*

"Technological conservatism produces an economic inertia that seems an apt description of the history of most societies that ever existed. The pervasive influence of the status quo, tradition, custom, routine, and adherence to precedent were powerful obstacles to innovation and advances. When technological progress occurred, it did so in the face of considerable odds."

Hubbard and Kane

A cartoon from 2009 that remains relevant



What about Europe?

Middling economic growth has been the trend in much of Europe for so long that it has its own name—Euro-sclerosis. Helicopter government policies have long been active in Eurozone (EZ) countries.

This past spring's Brexit was in part a rebellion against the EZ helicopter parenting.

To quote Hubbard and Kane one last time; *"Greece's troubles were not just the bursting of a bubble, but the collapse of an illusion. The illusion, one enjoyed by most Europeans, was that there was a pan European prosperity, as if European productivity levels were near or approaching the global frontier of entrepreneurial growth".*

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