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Productivity and the Wealth of Nations **by George C. Leef**

The Power of Productivity by William W. Lewis
(University of Chicago Press 2004); 323 pages; \$28.00.

“Watch the pennies and the dollars will take care of themselves,” Benjamin Franklin said. We might, in a similar vein, explain the key message of William Lewis’s book *The Power of Productivity* by saying, “Watch the productivity, and prosperity will take care of itself.” And the way to watch the productivity, he concludes, is for government to stop obstructing it.

Readers of *Freedom Daily* already know that, of course. In fact, I recently reviewed here a book entitled *Just Get Out of the Way!* making very much the same point the present volume does. The fact that governments soak up resources, impede economic efficiency, debase currency, prevent trade, and do many other things that get in the way of productivity has been known for a long time. So why bother with another book on that subject?

What makes *The Power of Productivity* so interesting is that it was not written by a “right-wing” economist. The author isn’t an economist by training at all. Lewis is a physicist who became a partner in the international consulting firm McKinsey & Company and founded the McKinsey Global Institute. He had the ear of officials in the Clinton administration, especially Robert Reich, secretary of Labor, and contends that presentations by his McKinsey team were responsible for altering the course of Clinton’s economic policy away from regulation and toward markets. Therefore, the book cannot be dismissed by those on the left side of the political spectrum as the scribbling of a dogmatic free-marketeer. So perhaps there is a chance that they will read it and learn some important lessons about how the world really works.

Lewis, as noted, is not an economist, much less an Austrian economist, but he has figured out one of the key tenets of sound economic analysis — you have to look at the micro level if you want to know what causes some nations to prosper and others to remain stagnant economic backwaters. No Austrian told him to focus his attention on individual industries instead of reams of macroeconomic data. He just figured it out. Referring to macroeconomics, he writes,

It's like trying to understand our physical universe using only the telescopes of astronomy. Any real understanding comes from studying how the tiniest particles in the universe interact in the depths of massive stars.

His McKinsey team therefore spent 12 years in minute analysis of a dozen countries ranging from the most prosperous to the exceedingly poor. This remarkably clear book explains their findings.

What makes nations wealthy?

One of the most basic lessons of economics is that people must produce in order to consume. With that truth as a starting point, Lewis proceeded to ask what some countries are doing right and others are doing wrong. Paying no heed to the “conventional wisdom,” some of his main conclusions are:

- If poor nations take care of their production problems, then (and only then) will the capital they need for modernization flow in.
- Education is not immediately important — since workers learn most of what they need to know on the job, pouring resources into formal schooling is unnecessary.
- Distorting markets to achieve “social equity” is a bad idea.
- Distortions in competition in product markets are much more damaging than are labor- and capital-market problems.
- Today's big governments in poor countries are a great handicap that today's rich countries did not have when they were at a similar stage of development.
- Consumers are the only political force that can stand up to producer interests, big government, and the technocratic, political, business, and intellectual elites.

Brazil

The details Lewis provides about the countries he studied are fascinating. Brazil, for instance, is a nation divided between an affluent, “First World” sector and a desperately poor — and much larger — “Third World” sector. The big cities gleam with modern buildings, but they're ringed by miles of pitiable slums. Most of the nation's commerce is carried out in the

“Third World” sector, which is beyond the reach of the taxing authorities. The problem that creates is that in order for the state to collect the taxes it needs for its prodigious expenses — Lewis points to, among other things, the ridiculously generous pensions paid to government workers — taxes are very high on the relatively small number of “formal” businesses. That high taxation prevents them from expanding.

Here we get back to the theme of productivity. Formal business enterprises are far more efficient than are informal, “off the books” ones. They make use of economies of scale to produce more consumer value for the resources used than informal businesses can. The trouble is that the heavy burden of taxation wipes out their competitive advantage. Thus, big government keeps most of the Brazilian economy stuck with the same kinds of businesses as existed 300 years ago. So if you feel sorry for the poor and want to see their lives improve, instead of looking to more government programs as the solution, you should favor a dramatic downsizing of the Brazilian state.

Russia

Lewis also gives us a fascinating chapter on Russia. While communism has been officially buried, its ghost haunts that country at every turn with market distortions that are ruinous to economic progress. “Russia distorts the ground rules for competition to such an extreme that businesses do well not because they do better, but for other reasons,” he writes. Resources remain trapped in inefficient enterprises that have changed little since the Soviet era, because local governments order unproductive firms not to shut down.

The steel industry is a good example. Many Russian steel mills are technologically obsolete, only 30 percent as efficient as American firms, and environmentally destructive to boot. In a rational economy, those plants would have shut down years ago. They can’t even pay for their use of energy. Local governments, however, control the distribution of energy and they don’t want “their” industries shutting down. Therefore, Lewis says, “The steel plants pretend to pay the local distribution companies with barter goods whose value is grossly overstated.” To make matters worse, the underemployed steel workers won’t relocate in search of better jobs because “the registration system ties social benefits to the worker’s current residence. Thus, workers have a disincentive to move anywhere.”

The steel industry is just one of many where government policy props up inefficient businesses and thereby obstructs the growth of modern, state-of-the-art firms. Even if the international food-retailing giant Carrefour, for example, wanted to enter the Russian market, it couldn’t make any money in the country’s terribly distorted economy.

India

India is another pathetic picture, captured in ugly detail by the author. To give just one instance of India's hostility to the free market, the nation has a "small-scale reservation" law that restricts investments in fixed assets to \$200,000 for firms producing more than 50 percent of their output for the domestic market. The idea is to protect existing producers against competition from larger and more-efficient businesses. In India, the great enemy of modern productive efficiency is, Lewis writes, "Gandhi's reverence for the traditional, self-sustaining Indian village." While Indians who leave the country often prosper, the country is stuck in an antiquated rut, thanks to government policy.

A pro-business public policy

The essence of the trouble in all the countries Lewis studied is that public policy is aligned with the interests of the producers and governing elites and against the consumers. Even though there is quite a lot of anti-competitive special-interest legislation in the United States, compared with the rest of the world, the United States looks like a paragon of laissez-faire virtue. In most other nations, ruling elites, business managers, and labor unions rig the economic game in such a way that the creative destruction of capitalism can't work. When production takes a back seat to "social objectives," the poor remain poor.

Is there any prospect that the obstructionist alliance of those interest groups will give way to consumer-friendly regimes that will allow the dynamics of the free market to work? Lewis recognizes that the deck is stacked against any such outcome. What the poor countries desperately need (and what would also be a considerable benefit in the more advanced countries as well) is a great reduction in the burden of government. Unfortunately, such reductions have hardly ever happened. Ireland and New Zealand are two cases where government was substantially downsized, but it is not likely that such cases will be replicated. Lewis suggests that the World Bank might use its influence to draw nations away from their anti-competitive ways, but even if World Bank officials could be persuaded to take that course, I think it doubtful that the political elites in nations such as Brazil and India will go along with pro-market changes. After all, doing so would mean a reduction in their power. Lewis himself does not seem very optimistic.

Reservations about the book

There is so much rock solid good sense in this book that I hesitate to cavil, but from a libertarian perspective, some cavils are much in order. For one thing, Lewis erroneously follows the conventional wisdom on antitrust law, saying that it is part of the "consumer orientation" that protects Americans from monopolization. He seems unaware of the strong case that antitrust serves to protect *competitors* rather than *competition*.

Another disagreement I have is with Lewis's assertion that, while big government is an obstacle to economic growth in developing countries, the United States needs it. He notes that countries such as Brazil and India today have governments that are comparable in size to that of the United States and makes the point that when America was at a similar state of economic development (in about 1913), its government was much smaller. But, Lewis writes,

we wouldn't go back there even if we could. The rich countries have learned some valuable lessons the hard way. We know how to achieve macroeconomic stability. We need an independent central bank . . . with a mandate to control inflation and keep the economy running near to full capacity. . . . We need to keep government deficits in check.

It's almost astounding that someone who can so competently analyze the absurd and destructive economic policies of many nations could write something as wrong-headed as that. Lewis shatters a lot of conventional thinking on economic policy throughout the book but remains trapped in it when it comes to the United States. It is standard liberal dogma that we need plenty of government spending and a manipulative central bank to give us economic stability. We don't, and it's too bad that our erudite author is unfamiliar with the writings of the economists who have crushed the Keynesian model. If the United States could restore the comparatively microscopic government of 1913, our economy would benefit enormously.

So Lewis gets a few things wrong. The big points in the book are dead-on accurate and carry the book admirably. *The Power of Productivity* is like a Supreme Court decision that is solid in its constitutional footings, but contains a few erroneous obiter dicta.

This book could have a lot of influence in a "Nixon goes to China" sort of way. Liberals who read the book might have to admit that a lot of the interventionist policies they clamor for to "protect" people from the effects of free-market competition are terribly myopic. Most liberals have a big psychological investment in the supposed evils of capitalism, but this devastating indictment of anti-market policies could cause some to reconsider.

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