Economic Growth Theories Fall into the Dustbin of History (And That's Okay)

Jane Shaw Stroup

June 6, 2023

"The Soviet model has surely demonstrated that a command economy is capable of mobilizing resources for rapid growth and awesome power," wrote Paul Samuelson in 1985 in his famous text, *Economics,* then written with William Nordhaus. (He noted, however, that the human toll in political repression was high.)

Four years later the Berlin Wall fell and the Soviet Union began to break apart, largely due to its internal economic weakness.

Perhaps faulty information from the CIA led Samuelson to miss what was actually going on in the Soviet Union. But, at the same time, Samuelson and other prominent economists did something equally sad. They failed to figure out what causes economic growth in underdeveloped "Third World" countries.

Looking through a sampling of editions of Samuelson's textbook (from 1951 to 1995 editions) you can see what he and leading economists were saying about how countries develop economically.

Samuelson's first edition was published in 1948. The second, in 1951, did not address developing countries.

In 1961, however, Samuelson was optimistic. He fancifully created a developing country, "Alertia," and recommended that she follow some basic, mostly Keynesian, principles. Alertia's government should improve the tax system, provide "social overhead capital" (infrastructure), make government loans to the private sector, and retire public debt.

Alertia "presents a fascinating spectacle," he wrote. "No one knows quite where she is going; but to everyone this much is clear: She is on her way."

Not What Had Been Wished For

But no, she wasn't on her way. In the next edition Alertia had disappeared. Economic growth turned out to be more difficult than it seemed.

On the bright side, however, numerous economists were on the job addressing the problem. "The key word in most economic discussions these days is growth," Samuelson wrote in the 1964 edition. He shared with his readers the evolving growth theories. A few:

- Walter Rostow's "take-off" theory: Leading industrial sectors lay the foundation for a broader "take-off" of economic growth.
- Alexander Gerschenkron's "backwardness" theory: The availability of already-invented technology should shorten the industrializing process.
- "Balanced growth," the idea that governments should invest in multiple industries at the same time: This was proposed by several economists (not named by Samuelson) but also approved by Simon Kuznets.

Other buzzwords cropped up, too, such as "infant industry" and "export promotion." To be fair, Samuelson did not agree with all the theories and never wavered from the value of trade.

But by the twelfth edition, published in 1985 (with Nordhaus), even Samuelson had become discouraged. The book discussed the "vicious cycle of poverty," suggesting that prosperity might never arrive:

Low incomes lead to low saving; low saving retards the growth of capital; inadequate capital prevents rapid growth in productivity; low productivity leads to low incomes.

He and Nordhaus conceded that getting the right formula isn't easy: "[S]aying that successful countries must grow rapidly is like saying that an Olympic athlete must run like the wind." It doesn't take you very far.

So in the end, the experts' economic theories of growth didn't pan out. But something else did: economic growth itself!

Unbeknownst to nearly all of us, the underdeveloped countries *were* developing. Most of the experts didn't see it, but it was happening: Innovation in transportation and communication were dramatically cutting the costs of trade, and ballooning trade was lifting people out of poverty.

The prosperity of the developed world quietly began to seep into the rest of the world, starting in the 1950s.

A Forgotten Source of Prosperity

One reason for the failure to see this was our seduction by the Industrial Revolution (1750–1820). We tend to think that such a period of magnificent innovation had done it all. By launching prosperity with its textile mills and factory production, it laid the foundation for the rest of the world to do the same. In fact, one of the theories—Alexander Gerschenkron's "backwardness" theory—said this explicitly. It should have been easier for countries to develop after the Industrial Revolution, because the technology and the organizational methods were already there.

But, in fact, the Industrial Revolution had missed most of the world. Only about 15 percent of the population —the United States, Europe, Japan, and a few other pockets of success—benefited directly, and that imbalance continued for more than a century.

We know this now because economists Joseph Connors, James Gwartney and Hugo Montesinos looked at the numbers in a 2020 article in the *Cato Journal*. Here are a few of the many numbers:

- Between 1820 and 1950, the GDP of the group of countries we now describe as developing (but outside sub-Saharan Africa) grew less than half percent a year, or 68 percent by 1950.
- In contrast, between 1960 and 2015, the per capita GDP of those countries increased by 549 percent.
- Although sub-Saharan African countries grew more slowly, their economies grew by 65 percent in the short period between 2000 and 2015.

The elevation out of poverty did not come about because of "take-off" or "balanced growth" or any such thing. As Connors, Gwartney, and Montesinos make clear, cost-reducing innovations—from the container ship to the internet—created a transportation-communication revolution that boosted the volume and extent of trade around the world.

Trade itself increases wealth, but more trade had other effects as well: It led to greater labor specialization, rewarded entrepreneurship and good business management, and pressured governments to adopt better policies.

And it even led to a "virtuous cycle of economic development." As wages increased, families had fewer children (the opportunity cost of bringing them up had risen). This meant that a higher proportion of the population was in the prime working ages and had greater interest in developing human capital through education and skills training. These improvements built upon themselves.

So, while prominent economists were spinning their unsatisfying theories and lamenting the vicious cycle of poverty, the world got better—on its own.