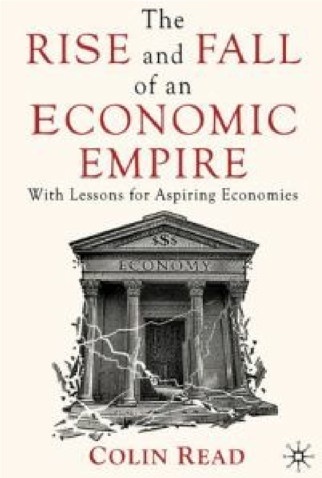

Book The Rise and Fall of an Economic Empire

With Lessons for Aspiring Economies

Colin Read
Palgrave Macmillan, 2010
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Recommendation

Economic empires, like their political or military counterparts, tend to sow the seeds of their own destruction once they've reached their peaks. From those lofty heights, arrogance, changing consumption patterns, altered social expectations and, ultimately, a reversion to government to keep the financial engine going, all foretell an inevitable decline. So says Colin Read, an economics professor at the State University of New York, in his ambitious treatise on economic empires. He offers a thorough, if disordered, trip through economic history, while critiquing the problems of global empire. Though his text is challenging in its density and breadth but short on solutions, it is a solid introduction for students of economic history. *BooksInShort* recommends this book mostly for an academic audience who believes that those who ignore history are doomed to repeat it.

Take-Aways

- Economic empires decline when they grow too dominant and their flaws emerge.
- Technology accelerates the pace of financial change; the UK, the US and, soon, China each will have held the title of world's largest economy within a 100-year span.
- The first market economies began as agrarian societies about 23,000 years ago.
- The Industrial Revolution introduced economies of scale to production that led to enormous wealth and a new middle class.
- But overproduction leads to "dis-economies of scale" that diminish returns.
- The American Founding Fathers espoused free enterprise, and urged delegating taxation and monetary policy to government.
- Industrialists Cornelius Vanderbilt, J.P. Morgan and Andrew Mellon led the "Second Industrial Revolution" in 1874 that propelled the US to new financial heights.
- Affluent economies shift from production to consumption, slowing their economic growth.
- Economists debate government involvement in free markets but agree that recessions require government aid.
- Advanced economic empires need innovation, reflection and renewal to maintain their status.

Summary

Economic Hegemony

Economic empires no longer evolve over many generations, as they once did. Over the past 100 years, the US ousted the UK as the world's largest economy, and soon China likely will take the title. Technology and information accelerate the pace of modern financial change, but economies still follow innate cycles and obey natural laws. For example, entrepreneurial businesses exemplify Charles Darwin's rule on the survival of the fittest, and massive entities collapse under their own weight according to "the Law of Diminishing Returns." All economic powerhouses are subject to this law, which states that no entity can grow too large or dominant before ultimately it falls prey to its own weaknesses. The US, which began to dominate global trade and finance after World War II, shows signs of incipient economic frailty, exemplified by the financial crisis and recession of 2008. How the world's economies will adapt to shifting roles is uncertain, but history can provide useful lessons for the future.

In the Beginning

Economic forces are as old as mankind itself and probably predate humanity: Ants and bees establish intricate hierarchies in which they allocate labor and resources in a market setting. Human economics arose when people began growing their own food. Early agrarian societies began in Syria about 23,000 years ago, when nomadic peoples discovered they could build static societies on agriculture, rather than on constant migration in pursuit of food. By remaining in one place, tribes could spend their energies on devising better production techniques, shelter and food storage.

> "The Law of Diminishing Returns proves that no institution can grow too big."

These new settlements produced a division of labor: Some people tended crops, some hunted, and others were free to pursue new activities that led to advances in language, writing and complex tools. In the process, people learned to control their environment. As society and markets developed, political clout devolved to those who amassed economic power by controlling scarce resources, starting with food. Those who produced more owned more, and exercised their power to "command and control" economic activity. As agrarian societies grew, production surpluses fueled trade. Barter yielded to common currencies, which offered markets a more fluid medium to establish prices. Differing supplies and demands for products led to currency exchange rates. Cash facilitated more trade, paving the way for more sophisticated societies and economic transactions.

> "The very forces that ensured growth and dominance of an institution in one era can contribute to its decline in another."

But one "seed of decline," taxation, can undermine command-and-control economies. Because centralized economies stifle individual autonomy, underground economies emerge, allowing participants to evade taxes. For example, recent estimates show that 40% of Greece's current GDP goes to supporting its public sector. However, Greeks feel they don't receive its full benefits; as a result, 25% of its private economy is underground and not subject to taxation. Inflicting more taxes doesn't necessarily mean more government revenue, an observation first made almost 700 years ago by a Muslim philosopher and subsequently resurrected in the 1980s by economist Arthur Laffer with his Laffer Curve, which showed diminishing returns from higher tax rates.

Economies and Diseconomies of Scale

Political and military empires throughout history follow the same trajectory: Rome, England and Nazi Germany all relied on armies to expand and maintain their empires. Economic empires also share common traits: Their strength derives from producing tremendous surpluses that convert into riches.

> "There is something timeless about the association of power with wealth for those who command the scarce resources that satisfy human wants and needs."

In 1776, philosopher Adam Smith was the first to cite the Industrial Revolution as an example of how achieving economies of scale enables nations to build wealth. Smith used the example of a pin factory, whose workers toiling together produced a much greater number of pins than each employee could make alone. Chicago's meatpacking industry pioneered the assembly line, which Henry Ford adopted. Synchronized stages maximized processing speed. Workers only had to manage a single skill, but if their pace faltered, they would slow the line. As a result, speed became a worker's most important attribute.

> "The most basic markets are as old as agrarian economies themselves."

The economies of scale derived from automated manufacturing allowed the price per unit produced to decrease as productivity rose. However, if production increased too rapidly, or too much of a product created a glut in the market, dis-economies of scale raised costs and decreased efficiency. "The Law of Diminishing Marginal Returns" recognizes that economic efforts can reach a maximum level of effectiveness, after which they deteriorate and fail. Accordingly, "one industrialist cannot dominate all manufacturing, or...one economic empire cannot subsume the entire global economy." Yet empires often chase growth for its own sake, and therein lies one of the seeds of their decline.

The "First and Second Industrial Revolutions"

By 1776, the American colonies were demanding their freedom from England, a phenomenon that constituted the first time economic rights, not political power, drove a challenge to established authority. Economic and philosophical thinkers of the era debated concepts such as the right to private property and due process. Smith wrote of the "invisible hand" that governed market supply and demand. This "force of self-interest" dictates that buyers and sellers should be able to produce and consume freely, according to their needs. The Founding Fathers espoused the entrepreneurial approach to wealth over prosperity gained from privilege. They enshrined the distinction between rights and privileges in the basic documents establishing the United States. The Founders eventually allocated to government, within the Constitution, the power to levy taxes, manage the money supply, promote trade and protect private property.

> "The monetary system, and the markets it facilitated, was precisely the mechanism that undermines the brute force, command and control empire."

The First Industrial Revolution of the 1800s exploited economies of scale and introduced new technologies to factory production. The new wealth spawned a rich middle class that threatened the historical dominance of the ruling elites. It also created a poor, urban working class that didn't share in the benefits of industrialization. Economists John Stuart Mill and Karl Marx proposed opposite solutions to this growing social dissonance: Marx advanced returning the means of production to the workers, while Mill posited that education could raise the poor's overall standard of living, and thus avert class conflict.

> "It was not until relatively recently that the advantages of markets, specialization and the innovation of power and transportation came together to produce

new goods and wealth unprecedented in 10,000 years of human history."

While the First Industrial Revolution disrupted rural life in England as unskilled laborers moved into cities, the Second Industrial Revolution drew on America's vast natural resources, immigrant labor and freewheeling mentality. Beginning around 1874, the Second Industrial Revolution entailed the development of railroads, steel mills, oil pipelines, automobiles, banks and factories, by iconic industrialists Cornelius Vanderbilt, J.P. Morgan and Andrew Mellon. The Gilded Age's rapid creation of economic power was the first time great wealth originated outside of conquest, inheritance or political power grabs. This Industrial Revolution, little more than 100 years after America gained independence, provided the boost for it to later become the world's largest economy.

> "To call a corporation ruthless is perhaps to call a lion ruthless. It is simply in the nature of a corporation to pursue profits by any legal means."

The nouveaux riches of the Second Industrial Revolution had more in common with their employees than with any aristocratic elites. Some industrialists understood their philanthropic responsibilities: Andrew Carnegie advocated a "Gospel of Wealth," using his riches to build libraries, museums, hospitals and schools. "Sharing the wealth" in this way precluded government interference to redress social inequities. Yet by 1886, the American Federation of Labor had formed to counterbalance the monopoly power of the huge corporations. Ten years later, the Progressive Age began the reform of corporate and political excesses fomented by years of unfettered prosperity and weak regulation.

> "Government prone to laissez-faire economics finds it impossible to stay ahead of economic evolution."

After a series of financial panics in the late 19th and early 20th centuries, often caused by railroad and bank failures, America's middle class bogged down in borrowing, consumerism and speculation. For the eight years preceding 1929, the stock market rose 500%, much of it fueled by small investors who were wiped out when the market collapsed in October 1929. The Depression took hold as 15,000 banks failed, destroying the savings of millions of Americans. The magnitude of the crisis gave rise to an activist Federal Reserve, increased federal spending and government intervention to address the problems unregulated markets cause. Despite the financial gains free enterprise delivers, government needs to stand by to take away "the punchbowl during a fantastic party."

Neocolonialism and the Influence of Multinationals

Surpluses create wealth and income. When people earn more than they spend, they invest this excess in the markets, which in turn fuel investments in a nation's infrastructure or manufacturing base, thereby increasing its productive capacity and creating more wealth. But these "positive feedback loops" prove the Law of Diminishing Returns: Greater affluence results in more spending, lower savings and fewer investments, accompanied by an increase in the size of government. When people emphasize short-term rewards over long-term goals, savings decline and growth slows.

> "The affluent economic empire falls into the trap of conspicuous consumption."

So for economic empires to expand, they must find new markets for their goods. Just as nations built colonies in the 18th and 19th centuries to seek new geographic markets, so, too, do multinational corporations practice neocolonialism to acquire new consumers or raw materials. Modern multinationals exert control over many sovereign nations; companies with monopsony power – that is, those that can dictate their buying terms – maintain their profits by stemming local economic growth, often by paying low wages. By creating dependency in their host countries, companies can extract large concessions from local governments in the forms of tax deals and infrastructure subsidies.

> "Economic dominance gave rise to a new colonialism."

But global empire building has some built-in inefficiencies. For example, multinationals constantly look for lower-cost suppliers and cheaper labor sources. But over time, these costs rise as a result of invigorated economic activity. Technology also shortens the time frame of economic dominance. The rapid transfer of technological knowledge and applications (from supply chain management to production processes) has reduced developed nations' advantages over developing nations. For example, the Internet's global reach has helped propel growth in China, making it the world's second largest economy. If it can maintain its double-digit growth rates, China's economy will supersede that of the US by 2021. Yet, China's predicted economic superiority may be relatively short-lived. Britain was a dominant world power for 200 years; the US enjoyed the top position for 100 years. Global competition and rapidly accelerating communication may fuel even faster shifts among top economies.

"The Winner's Curse"

Strong economies that provide wealth shift their citizens' focus from needing products to desiring services, particularly luxuries. Once people's basic requirements are met, "conspicuous consumption" reigns, and "an economy can move from production of machines on Main Street to the production of wealth on Wall Street." Surplus wealth also spurs concern toward those less fortunate. Government steps in to provide social services that private enterprise will not, and thus grows the machinery of public policy.

> "An economic empire that fuels its substantial growth because it subscribes to the free market system is also more vulnerable to economic shocks, recessions and depressions."

In an attempt to ensure good financial development, government seeks to manipulate free markets for labor and capital. In the 1930s, economist John Maynard Keynes addressed the issue of how to manage demand in times of crisis. Keynes recognized that an increase in the money supply to consumers would boost spending, which would spur new bank lending, create jobs and get the economy moving again. Government intervention, though, inevitably results in either higher taxes or higher national debt. While many economists debate how much government intervention is enough and whether it works at all, they agree that recessionary times require government help in some form. As the 2008-2009 recession indicates, economic empires can slide rapidly, ruined by the same sophisticated skills that created their economic power in the first place.

> "A great civilization is not conquered from without until it has first destroyed itself from within." (historian William James "Will" Durant)

Another reality of rich economies is their transition from relying on the private sector to depending on government to furnish the engine of new growth. In the process, the affluent society shifts its consumption pattern toward leisure, which doesn't contribute to the nation's GDP. As a result, economic progress slows, with "a greater emphasis on the distribution of the economic pie rather than on the creation of the economic pie."

> "The laboratory of the modern economy is still experimenting."

Like a long-distance runner with a comfy lead, entrenched empires rarely anticipate who or what can take the race from them. Arrogance and complacency sets in – "the very arrival at the apex of an economic trajectory is the point at which an economy transitions from the chaser to the chased." Of all the stages of economic evolution, this is the point that presents the utmost challenge: how to maintain predominance when natural cycles predict demise. But reflection, innovation and renewal can spur "a new economic order."

About the Author

Colin Read is an economics professor at the State University of New York College at Plattsburgh