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Remember innovation [1]

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For the first time in decades, Britain's economic growth is stagnant. With a predicted -0.1% for 2012, Treasury forecasts for the years ahead look wildly optimistic. Yet the Chancellor's tinkering around the edges is unlikely to achieve much. The problem is that the debate over achieving higher economic growth totally ignores its causes. It forgets the important distinction between what the Nobel Laureates Kenneth Arrow and Robert Lucas Jnr. describe as "level effects" and "growth effects".

Level effects are one-off shifts that cause some economic growth by reshuffling resources to their most valued uses. For example, pushing for free trade and the division of labour are only likely to get you so far. They allow resources to be reallocated towards more valuable uses, but they don't substantially alter the trajectory of economic growth. Adam Smith, David Ricardo and Thomas Malthus, all champions of the gains to trade, recognised this. They thought that after tearing down domestic and foreign barriers to trade, that growth would eventually plateau to a stagnant, "stationary state". 17th Century Holland would be a pretty good approximation of where they expected the pinnacle of economic progress to be.

Advanced as it was for the age, 17th Century Holland doesn't remotely compare to today. Fortunately for us, growth effects can put us on a trajectory of sustained economic growth, with innovation as the crucial factor. What Smith, Ricardo and Malthus didn't see coming was the Industrial Revolution: not steam and chimney stacks, but a wave of sustained innovation in all industries. In a nutshell, modernity began. Britain became the envy of the world not only for its ability to invent, but its remarkable capacity for adopting others' inventions and making them work. An instructive contrast is between France and Britain. France poured significant government funding into trying to make industrialisation work, and had lower taxes and lower external trade barriers too. Yet Britain had the comparative advantage in innovation, trumping all. It undermined taxing governments, guilds and aristocracies in the 1770s, and endured 1970s socialism too.

If Britain really wants sustained economic growth, it needs to radically improve the conditions for innovation. But this requires a cultural change as well as government allowing it to take place. The eminent economist and historian Deirdre McCloskey describes this as the dignity and liberty for innovation: a willingness to embrace and celebrate the creative destruction of new products and processes supplanting the old. Modernity was born when Britain went from condemning Shakespeare's Shylock in *the Merchant of Venice*, to honouring James Watt with a statue in Westminster Abbey. But we are in danger of falling back into the ancient distaste for commerce and innovation. As Allister Heath rightly pointed out in his address to the ASI Christmas Party, we must combat the emerging politics of envy and redistribution, and embrace the optimistic impulse of innovation.

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