

Michael Kotrous

Creighton University – Class of 2015
michaelkotrous@creighton.edu

Economic Growth and Income Inequality: A Public Choice Analysis

Abstract

Joseph Schumpeter predicts the end of capitalism as a slow decline in the system's ability to generate growth. As the average income of a country increases, the social focus shifts from promoting economic growth to maintaining a minimum standard of living for all. From a Schumpeterian perspective, doing so requires actions by governing institutions to slow entrepreneurial innovation that fuels the capitalist engine of growth but has adverse effects on certain industries and classes of society. The intention of these interventions is to promote "fairness" and income equality while maintaining a steady but relatively slower rate of growth. Public choice theory suggests this belief in institutions to promote the "common good" is naïve. What we are likely to see, Tullock (1967), Stigler (1971) and others argue, is institutional intervention that protects businesses from competition, which works to reduce innovation that drives growth, and prevents transfers of wealth from the upper to lower classes by regulatory capture. Public choice theory, then, suggests that the state of socialism envisioned by Schumpeter, with decreasing growth and increasing income equality, is unlikely, if not impossible.

1. Introduction

Following the great recession, political rhetoric and economic analysis has focused on the issue of income inequality. The depth and duration of the most recent recession led to the questioning of the status quo and a realization that the developed economies of the world remain vulnerable to strong swings in the business cycle that expose the least well off to the greatest amount of risk (e.g. long-term unemployment). For instance, Piketty's (2014) analysis of historical data from the developed nations of the world suggests that income inequality will continue to grow at an alarming rate, even though rates of growth are also predicted to decrease, due to declines in population growth and other factors. Piketty concludes that the simple relationship $r > g$, which states the returns of capital will exceed wage growth, will define the future of the capitalist system.

Correcting for income inequality, then, requires government intervention to redistribute income to lessen the gap between wealthy and poor. Policy recommendations like Piketty's are what the twentieth century economist Joseph Schumpeter predicted would drive the collapse of the capitalist system in favor of a socialist system. As average wealth increases, policy is no longer motivated by growth. The emphasis of intervention in the economic system shifts to ensuring fair outcomes for all.

The conflict between these two outcomes of the economic system—productive efficiency and distributive fairness—is the topic explored in this paper. The workings of the economy are often evaluated on its ability to achieve two goals: 1) growing productivity at steady rates and 2) maintaining a minimum standard of living for all. With two potential outcomes for each goal, there are four combinations of possibilities concerning these two items:

1. Increasing growth and increasing income inequality (creative destruction),
2. Increasing growth and decreasing income inequality (Kuznets curve),
3. Decreasing growth and decreasing income inequality (socialism) and
4. Decreasing growth and increasing income inequality (“institutional stagnation”).

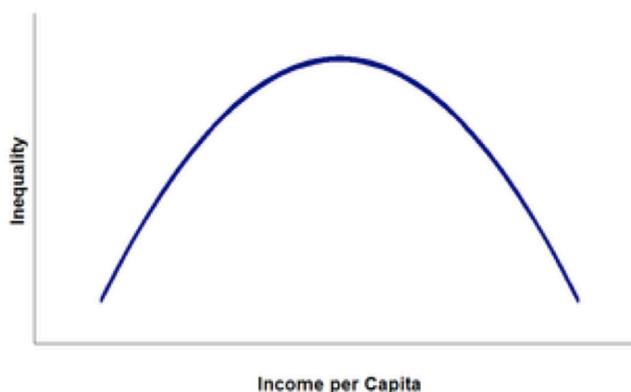
I argue that the state of socialism listed above, in which institutional interventions lower growth rates to a tolerable level in order to promote income equality, is impossible due to the shortcomings of institutions described by the public choice school of economics. This perspective allows for close examination of these four possibilities and informs us that the recent political mobilization of developed nations to address issues like income inequality and the swings of the business cycle will do little to achieve their stated goals while reducing the role of the entrepreneur in driving economic growth due to the misalignment of political incentives and social goals.

The remainder of this paper is structured into four sections. The second section of the paper considers different institutional perspectives on economic growth and income inequality. The third section presents an analytical model based on those perspectives, and the fourth section presents the core of my argument—that . Concluding thoughts will follow that.

2. Perspectives on Economic Growth and Income Inequality

In 1955, the economist Simon Kuznets wrote the seminal paper that sparked the economic interest in the relationship between economic growth and income inequality. In that paper, Kuznets advances the hypothesis that as an economy moves from low-income to middle-income, an increase in income inequality will be observed. Then, as the country moves from middle-income to high-income, income inequality will round down past the peak and continue to decrease. This relationship between economic

Figure 1: The Kuznets curve



growth and income inequality, usually approximated with the Gini coefficient, is shown in the chart in Figure 1, which is popularly named the “Kuznets curve.” Kuznets hypothesized that this pattern of economic development was observed as a country underwent urbanization—that is, the nation’s labor force moved from work in the agricultural sector to the industrial sector (1955). The large literature testing Kuznets’s hypothesis has returned mixed results, at best (Acemoglu and Robinson 2002). The Kuznets curve, and of Acemoglu and Robinson’s institutional argument for the Kuznets curve pattern of development are discussed in the first subsection below.

2.1. An Institutional Perspective on the Kuznets Curve

Acemoglu and Robinson (2002) put forth an alternative argument that the Kuznets curve can be explained by a process of political change within a nation. That is, the observed Kuznets curve comes from a shift away from the growth motivation towards the equality motivation. When a nation reaches high levels of income inequality, citizens are prompted to engage in political mobilization. The authors argue that these institutional changes advocated by the disadvantaged favor democratization and bring about a system that favors progressive taxes and income redistribution, which work to reduce income inequality as the nation continues to experience economic

growth. "Before the nineteenth-century, political power in European countries was monopolized by a small elite, and as a consequence, most policies favored the elite, and there was little redistribution of income to the masses" (Acemoglu and Robinson 2002, 184). Implicit in this statement is that public policy in Europe, and by extension the United States, no longer favors a class of political elites. The scholars of public choice theory discussed later in this paper take issue with this statement. Acemoglu and Robinson (2002) conclude that democratic institutions are fundamental in economies achieving high levels of growth and decreasing income inequality.

The advantage of an institutional analysis of the Kuznets curve, the authors argue, is that it also provides a robust framework for explaining the development of nations that do not follow the Kuznets curve. The authors consider two exceptions that do not follow the Kuznets curve, both of which are "nondemocratic." First, a country may develop high inequality and low output with no political mobilization, which the authors describe as "autocratic disaster." Second, the authors describe the "East Asian Miracle." South Korea, Japan and other Asian countries have experienced economic development without considerable increases in income inequality, at least not enough to result in their predicted political mobilization.

Acemoglu and Robinson's (2002) institutional analysis of the factors that affect economic growth and income inequality is closely related to the goals and methods of this paper. In addition, the authors offer a hypothesis for the relationship observed between economic growth and income inequality in the spirit of Schumpeter's dynamic model of the capitalist system. "Overall, our theory of the Kuznets curve is that capitalist industrialization tends to increase inequality, but this inequality contains the seeds of its own destruction, because it induces a change in the political regime toward a more redistributive system" (Acemoglu and Robinson 2002, 184). The authors seem to

agree with Schumpeter that sociological shifts in societal values will drive changes in income inequality; a natural tendency of the capitalists system is to drive the relative gap between wealthy and poor farther apart. What Acemoglu and Robinson fail to acknowledge is the effects these political changes emphasizing redistribution of income will have on long-run economic growth. Later sections of this paper will discuss this matter.

2.2. "Creative Destruction": Joseph Schumpeter's Vision of Capitalism and Its Decline

In *Capitalism, Socialism and Democracy*, Joseph Schumpeter (2008) coins the term for which he is most famous—creative destruction. Creative destruction, Schumpeter writes, is "the essential fact of capitalism" (Heilbroner 1996, 310). As industries grow to take advantage of economies of scale and new industries emerge, aged industries are cast out and its laborers' skills rendered useless. In the Schumpeterian model of capitalism, no individual industry or laborer is guaranteed the opportunity to enjoy the spoils of aggregate growth. Thus, the two goals of productive efficiency and distributive fairness are put in direct conflict with one another; society cannot maximize growth and equality at the same time, if one reads Schumpeter's understanding of capitalism seriously. This trade-off, Schumpeter argues, drives the decline of the capitalist system.

Schumpeter lays the logical foundation for the process of creative destruction in an earlier text, *The Theory of Economic Development* (1983). In that text, Schumpeter establishes a circular model of the capitalist system similar to that of Say's Law. Goods are produced in the same way at the same cost year in, year out, which generate a sufficient amount of demand by their very creation. It is by this stagnant circular model of the capitalist system, which is purposefully made so unlike the actual capitalist system as to be unbelievable, that Schumpeter introduces capitalism's "white knight": the entrepreneur. Who is this entrepreneur? Simply, a member of a class of people that

exists in the tail of the natural distribution of intelligence. Capable of engineering ways to do something already done more cheaply or in a different way altogether, the entrepreneur is the spark to the capitalist engine of growth. According to Schumpeter, it is not the Smithian laborer with intimate knowledge of a task but an insightful outsider who generates innovation.

It is the successful entrepreneur, then, that is responsible for introducing the process of creative destruction to the economy. It is this “essential fact of capitalism” that creates the adverse consequences that will drive the sociological change Schumpeter predicts will end capitalism. Society, having reached a satisfactory level of wealth, will no longer tolerate the adverse outcomes of the capitalist system and will push change to the system that will ensure increased certainty in the welfare of all. What he predicts is not the explosive, violent Marxist overthrow by proletarian forces but a slow decay of the capitalist system. Schumpeter argues capitalism’s end will not stem from economic oppression reaching a breaking point but from sociological changes in perspectives concerning what an economy should do—from previously growing wealth to now ensuring a fair share. The economy will shift from one with frequent disruptions stemming from the process of creative destruction to one that has fewer disruptions of the business cycle. This change provides the advantage of fewer people being displaced by innovation; however, this change also threatens to cut the spark of growth in the capitalist system from its supply of oxygen, extinguishing the flame, which Schumpeter feared most.

Figure 2: Four Alternatives of Productivity Growth and Income Inequality

	Decreasing Inequality	Increasing Inequality
Increasing Economic Growth	Kuznets Curve	Creative Destruction
Decreasing Economic Growth	Socialism	Institutional Stagnation

3. Analytical Model

The possible combinations of income inequality and economic growth can be placed into a two-by-two matrix, shown in Figure 2. Economic growth, broadly categorized as high or low growth, is placed on the vertical axis, while levels of income inequality, broadly categorized as high or low income inequality, rest on the horizontal axis.

The quadrant considered a “natural” state of the capitalist system is creative destruction: entrepreneurs can freely enter and exit markets, even create new markets altogether. The other three states are possible outcomes that can be achieved by intervening in the Schumpeterian system of creative destruction. Kuznets’s (1955) original argument was a non-institutional one, but Acemoglu and Robinson (2002) discussed above present a compelling argument that observed decreases in income inequality as nations become developed is the result of policy change spurred by social advocacy. In this state, economic growth continues to increase, or at least remains steady. The state of socialism similarly is characterized by low income inequality, but advocates of socialism are characterized by a willingness to accept lower rates of growth.

The end states predicted the Kuznets curve and socialists both assume that institutional intervention will work to decrease income inequality. The third possible state that can result from government intervention in the process of creative destruction

occurs if these interventions fail, which I describe above as institutional stagnation. This state is a combination of low economic growth and high income inequality, similar to the future trend predicted by Piketty (2014). This state, Piketty argues, threatens the democratic ideals of meritocracy because high levels of income inequality and an increased importance of inherited wealth both work against social mobility among those born into lower-income families.

4. Analysis

The model established above assumes that creative destruction is the natural state of capitalism, or the state of affairs that prevails when markets are allowed to operate with limited amounts of government intervention. First, my analysis needs to establish creative destruction as the prevailing order in capitalism that drives growth and the business cycle. Then, my public choice analysis of institutional intervention can be presented.

4.1. "Creative Destruction": The Natural State of Capitalism

This section briefly elaborates on the implications of the disruptive forces of innovation, and potential ways for institutions to address the adverse consequences of creative destruction while preserving the motivation for entrepreneurial innovation (read the profit motive). As mentioned above, the entrepreneur creates innovation and "breaks" the circular flow of the economy by either finding a way to do an existing process more cheaply or discovering a new process altogether.

This innovation has serious implications for the firms and laborers who specialized in the now outdated method of production. Market theory says that incumbent firms will either have to lower costs to match the costs of their new competitor or shut down. This lowering of costs, at least in the United States, is usually done by reducing aggregate hours worked by employees, not reducing wages, which

tend to remain “sticky” even during great changes in employment levels (Hall 1980). These laid-off or fired employees have become, by definition, structurally unemployed.

An observed increase in job insecurity and job instability in the past few decades is an important factor in increasing income inequality observed in the United States. Jobs in several sectors, primarily manufacturing jobs, that were previously fairly secure have become insecure due to innovation, and the skill premium previously earned by those workers has been competed away. While the skill premium goes down in some sectors, it has increased in other sectors, meaning that the lowest wage earners and the highest wage earners are moving away from one another, increasing the income gap between top and bottom (Mendez 2002). In addition, a similar pattern of creative destruction has been observed in the United States in the 1920s (Nicolas 2003).

4.2. Potential Interventions to Curb the Adverse Effects of Creative Destruction

Creative destruction is characterized by gains in utility from entrepreneurial innovation (lower prices or new products, usually) being paired with the disutility for the structurally unemployed, which makes the process of creative destruction Pareto inefficient. The destructive forces of innovation do not necessarily have to be stopped entirely in order for Pareto efficiency to be achieved. Instead, institutions could tax and redistribute income in such a way that the structurally unemployed are fully compensated for their losses. Under this model of Kaldor-Hicks efficiency, citizens could enjoy the benefits of innovation and high growth in productivity while avoiding the risk of the disutility associated with becoming structurally unemployed. The Kaldor-Hicks compensation scheme, of course, assumes transition costs equal to zero. That is, no costs exist in the process of gathering information, collecting taxes and redistributing the incomes appropriately. In addition, Kaldor-Hicks assumes that the monetary losses experienced by the structurally unemployed can be properly measured,

regardless of the costs. In short, a system of Kaldor-Hicks redistribution—a so-called tax on growth—suffers from the “calculation” problem noted by Ludwig von Mises because preferences change frequently over time, and, as a result, so to changes the market value of a good or service (Stringham 2001). For instance, if the lost earnings of structurally unemployed workers were pinned to the current market value of their labor services, then the compensation may very well be calculated to equal zero!

Taken together, the problems of transaction costs and economic calculation undermine the possibility of supporting the Schumpeterian mode of capitalism, in which the adverse effects of creative destruction are countered by redistribution that achieves Kaldor-Hicks efficiency. Thus, it appears unlikely that the sociological and political changes predicted by Schumpeter and discussed by Acemoglu and Robinson (2002) can be effectively prevented.

The public choice school of economics analyzes political systems and voter decisions by assuming actors in the political sphere behave as they do in the economic sphere (i.e. on the basis of rational self-interest and utility maximization) (Buchanan 1999). Public choice literature suggests that Acemoglu and Robinson’s description of nineteenth-century Europe as favoring a class of political elites is not only a series of unfortunate mistakes to be found in history books but actually apt to defining the problems observed in modern political institutions. What Acemoglu and Robinson describe as “autocratic disaster” (a state of low growth and high income inequality) is not the result of moral failings of those who hold political office but the fundamental misalignment of the interests of the political elite and the common citizen, according to the public choice literature.

Stigler (1971), for instance, argues that all regulatory policies favor special interests, not public welfare. Given the scarcity and the high opportunity cost of

Congress's or a state legislature's time to debate and vote on legislation, lawmakers only consider legislation that has a large amount of financial and lobbying support. What makes legislation attractive to business interests is government's exclusive power to tax, redistribute resources and regulate industries as it sees fit. This makes government a popular avenue for firms to receive subsidies (e.g. airline "air mail" subsidies) or to seek protection from current and future competition in the marketplace (e.g. petroleum industry). By imposing barriers to entry of competition, government regulation works against economic growth by substantially increasing the costs an entrepreneur must undergo in order to enter the market.

In an influential 1967 paper, Gordon Tullock makes the observation that the welfare costs of monopoly likely exceed the traditional understanding of deadweight loss—defined as the transactions lost by the fact that monopolies can price their goods and services above the cost of producing them. Tullock argues that firms seeking to capture the transfer of consumer surplus to producer surplus that occurs when firms achieve monopoly status are willing to pay up to the expected gain in producer surplus in lobbying efforts. The goal of this lobbying is to pass legislation that grants protection from competition. On the flip side of the same coin, firms with legal protections from competition can be expected to spend up to the level of their gained producer surplus in order to protect their interests. "These expenditures... are purely wasteful from the standpoint of society as a whole; they are spent not in increasing wealth, but in attempts to transfer or resist transfers of wealth" (Tullock 1967, 228). This problem of "rent-seeking behavior," as the issue defined by Tullock came to be called years later, has serious implications for both economic growth and income inequality.

5. Concluding Thoughts

This paper has used a public choice analysis to evaluate the predicted end of capitalism predicted by Joseph Schumpeter, in which sociological and political changes will drive out the focus on economic growth in favor of “fair” outcomes for all. In addition, this paper discussed the Kaldor-Hicks compensation scheme as a potential solution to the problem of structural unemployment created by the process of creative destruction. However, the presence of transaction costs and the “economic calculation” problem (Stringham 2001) make such a compensation scheme problematic, at best. To address the harmful side effects of creative destruction, institutional intervention is required (e.g. Piketty 2014). The cited paper by Acemoglu and Robinson (2002) provides a strong argument for the important role of institutional change in changing the levels of income inequality observed in a nation; however, the authors do not extend the analysis to see how institutional change affects economic growth. The economic theory of regulation and rent-seeking behavior both suggest that government interventions will slow economic productivity. Taken together, the insights of public choice suggest institutional interventions aimed at addressing income inequality will not work to improve the common welfare but rather keep income inequality at steady, if not growing, levels while also reducing economic efficiency, productivity and growth.

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