

On Government Growth:
Competing Ideas from Schumpeter & Cowen

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Abstract:

The last century has witnessed an impressive growth in government expenditure as a share of GNP, particularly in developed countries, which otherwise generally exhibit factors conducive to open market economies. In this essay, I examine two possible explanations for phenomenon. First is the argument presented by Joseph Schumpeter, who thought that effect of the capitalist system on social institutions would ultimately be its own undoing. The second is a theory posited by the economist Tyler Cowen which assumes an innate demand for large government that technological advances have made easier to supply. I draw attention to the distinct, if nuanced differences, in their reasoning. While the short-run consequences of their arguments are similar, the long-view divergence may be critical to understanding not only why government growth has occurred, but what, if anything, may be done to reverse it.

Introduction: A View from Mt. Pelerin

At the turn of the 21st century government spending frequently comprises forty to fifty percent of gross national product in many developed countries, an incredible increase from roughly ten percent most countries averaged 100 years prior (Cowen 2). Attempting to explain this change to the Mount Pelerin Society in 2009, the economist Tyler Cowen emphasized the role played by technological innovation as part of a complicated causal relationship (Cowen 2). A casual audience member listening to Cowen's remarks may not help but be struck by certain similarities between Cowen's argument and Joseph Schumpeter's famous analysis of the capitalist system found in *Capitalism, Socialism and Democracy*. Such a casual listener may subsequently conclude that Cowen is assuming a Schumpeterian analysis of capitalism. In particular, one may note the similarities in Cowen's prediction of government growth as a share of GDP with Schumpeter's prediction that the capitalist system sows the seeds of its own demise. Despite certain facets of Schumpeter's analysis underlying Cowen's line of reasoning, I argue that such a conclusion would miss important distinctions that require critical consideration of the full arguments of both individuals. In what follows, I shall attempt to reconstruct both Cowen's

and Schumpeter's arguments and then analyze where Cowen's argument makes a distinct break from Schumpeter's, which leads them to quite different final predictions.

Schumpeter's Prediction

Schumpeter begins his analysis of the capitalist system by noting that it is fundamentally an evolutionary system and could not exist in a stationary state (Schumpeter 82). This continuous cycle of discovering new products, new production methods, and new forms of organization is what Schumpeter was referring to when he coined the phrase "Creative Destruction." The entrepreneur seeks out these innovations in the hope of establishing an effective monopoly and reaping large profits (Schumpeter 90). If successful, he earns membership into the *bourgeois* class. Even when individuals lose, the overall process is incredibly effective at generating wealth, particularly in an unprecedented way for the masses (Schumpeter 67-69). This cold, hard rationality of capitalism, which was largely responsible for overturning the feudal structure of early modernity, and generating unprecedented wealth, has the tendency to affect social institutions, including itself. Over time, the capitalistic function tends to automatize itself, relegating the "entrepreneur" further away from his profit motives and into the role of a risk-averse manager, who happily accepts lower returns on his capital in exchange for greater certainty.

The entrepreneur becomes decidedly "un-heroic," transforming from a knight in search of the Holy Grail to one in search of the rent-seeker's Rolodex (Schumpeter 137). Even contracts and private property rights begin to melt away as the machine of capitalism cannibalizes them in the name of efficiency (Schumpeter 141). After all, private property is a curious thing within a large, efficient corporation, and contracts allow a great deal of individuality and nuance that may be seen as wasteful in regards to time and resources, so both come to be seen as a barrier to

minimizing cost and maximizing profits (Schumpeter 141). In this regard, as Schumpeter vividly puts it, “In breaking down the pre-capitalist framework of society, capitalism thus broke not only barriers that impeded its progress but also flying buttresses that prevented its collapse,” ultimately leaving nobody committed enough to the process to defend it (Schumpeter 139).

At the same time that the system tears down its own defenses, it has opponents waiting in the shadows. The growing apathy of the entrepreneur is met by the emboldened social reformer. There will always be a large class of laborers that will see inequality in society and be dissatisfied, no matter how much their own position has been improved relative to conditions of the past, as they take overall societal progress for granted, but feel insecure about their own position in society in the moment (Schumpeter 145). Schumpeter measures inequality by wealth in the short run precisely because he thinks this is how the common man sees the situation. After all, the average person is rationally self-interested, caring for his lot in life at the moment: “In order to identify himself with the capitalist system, the unemployed of today would have completely to forget his personal fate...” (Schumpeter 145). This social unrest has two distinct facets, the inequality experienced from the workers’ view and the rhetoric stirred up by the intellectual class, which at its root makes its living by criticism, and thus must criticize the existing paradigm (Schumpeter 153). These forces, combined with the weakened support amongst the capitalist class, form a winning coalition for public policy that ultimately stifles the capitalist engine which made all this growth possible. Thus, capitalism requires extra-capitalist institutions to support it, which it inevitably destroys in its growth (Schumpeter 162).

Cowen’s Government as a Luxury Good Argument

Cowen’s argument is perhaps a bit less complex, but equally powerful. While being careful to note that he is not suggesting a monocausal relationship, Cowen posits that the role of

technology has been too overlooked in the explanation of the growth of government in the Developed World. He first cedes that there must be some demand for “big government” in the population already, but is willing to take this as a given for the purpose of analysis (Cowen 5). What technological innovation effectively did, then, is lower the costs of supplying what was already being demanded. Technologies that were quickly and widely adopted in the 19th century allowed for government and other large institutions to effectively communicate, organize, and coordinate. The rise of the railroads, automobiles and airplanes allowed a central government to spread its bureaucracy with relative ease. Conversely, ease of transportation allowed far-flung interest groups to more easily lobby their central government for preferential legislation, expanding the amount of regulation to enforce (Cowen 7). Technology lowered the costs of all things, and rent-seeking was no exception.*

Other technologies improved communication, allowing individuals to feel connected to their national identity in a way they never could in the past, and politicians could take advantage of this to expand power. Similarly, other technologies allowed a massive bureaucracy to communicate and coordinate in ways that allowed the tracking of individuals all over the nation, making national-level welfare programs a practical possibility for the first time (Cowen 9). Thus, not only national business, but national bureaucracy, became less costly due to this increased efficiency. The great wealth generated by these new technologies not only raised national incomes in the nations that adopted them, it made government-provided services more attractive. Government is in some ways a luxury good: the higher a nation’s income above sustenance

* Baumol’s “cost disease” reminds us that technology may sometimes have the adverse effect of raising prices in some industries relative to others if the given industry does not benefit as greatly from new technology. In this case, rent-seeking at the federal level seems to have benefitted greatly.

levels, the more it can afford to spend to assuage its conscience (Cowen 10). Taken all together, these technological changes make big government possible.

Cowen draws a further conclusion from all of this. Reformers seeking to shrink the size and scope of government ought not to look toward the past if we wish to shrink the size of government. It would appear that our ancestors demanded big government all along, they simply had no feasible means of attaining it. Rather, reformers must target shifts in demand, preferences changes, in the present (Cowen 18). How we are to actually realize these changes in preference is left a bit of a mystery, as Cowen notes that such preferences are outside the scope of his current analysis. He has identified shifts in the supply of government and shift in demand for government due to increases in real income caused by technology, but not why society holds such preferences (Cowen 19).

Is Cowen Omitting a Necessary Reference to Schumpeter?

In some sense, the parallels between the two authors are obvious. Both theories suggest that technological and systematic innovations, likely the result of a capitalist system, are linked causally to a growth in the size of government. Further, both claim that key changes in technology, namely those that lower real costs and thus increase real income, at least part of the demand for this growth may be attributable to the population viewing government as a sort of “luxury good,” at least in the sense that society must reach a certain level of growth and development for government to also grow. This is because they agree that a general discontentment with inequality plays a role. Why, then, should we not assume that Cowen is operating under, basically speaking, a Schumpeterian framework?

Perhaps the most fundamental difference is understanding the importance that technological innovation plays in both Schumpeter's and Cowen's theories and how it impacts supply compared to demand of government. For Schumpeter, technological innovation is the *central* mechanism of capitalistic growth by which society improves. But we must remember that under Schumpeter's schema, realizing greater technological potentials occurs only because entrepreneurs are seeking a monopolistic advantage in the market (Schumpeter 110). It is the growing general wealth of the long term, coupled with all the short run horrors caused by the "gales of creative destruction" that lead to a demand for government expenditure and government expansion. As Schumpeter notes, the capitalistic mechanism provides both the means and "the will" for new government growth (Schumpeter 127). By will, Schumpeter is specifically referring to the fact that the capitalistic system not only change our standard of living, but our end goals and preferences as well. The entrepreneur, who previously desired the freedom to seek out new ways to gain immense profit through incredible breakthroughs now seeks instead the certainty of modest returns, best secured by government restricting his competitors' ability to innovate and topple the status quo. The median worker, inclined to see his lot in life as it stands now, desires a greater share of the tremendous wealth circulating in society. But it is the public intellectual, the "second hand dealers in ideas," to borrow from Hayek, that finds a way to channel these various interests into a coherent political coalition that has the power to shape policy. That that intellectual gains in prestige and financial position is not lost on Schumpeter. The public intellectual exists as a critic of the existing system, whatever that system may be, so the intellectual's criticism of capitalism is in some ways a coincidence of nature. The intellectuals attack the current system for their personal advantage, not necessarily for a higher minded reason, which earns them prestige and secure jobs as columnists and bureaucrats

(Schumpeter 153). There is a deeply rooted institutional transformation that occurs under capitalism that affects what our society values. Ultimately, innovation is at the root of the eventual government expansion, but its causation is not direct. Rather, it is the trigger of a chain of events that lead to societal changes.

Compare this, by contrast, to Cowen, who explicitly rejects this important Schumpeterian notion of the economic system's impact on societal value and, accordingly, preferences. Cowen simply takes our desire to have a bigger government as a given, exogenous for the purposes of analysis (Cowen 5). For him, technology has no "butterfly effect." Presumably, Cowen finds something objectionable in Schumpeter's analysis and can only conclude that the demand must have always been present. It is admittedly interesting that an economist in the public choice tradition would object to what is, in part, a special interest theory of governmental expansion. The only effect on demand that Schumpeter and Cowen agree upon is possibly a shift due to the income effect, which is Cowen's "luxury good" argument. For Cowen, the most important effect of technological innovation is clearly on the supply side, as it allows for government, previously bounded by practical concerns of coordinating on a large scale, to grow beyond these restrictions. Schumpeter seems not to be concerned at all with the supply side implications of economic growth to the governmental equilibrium, or at least takes it as a given.

Further, Schumpeter and Cowen do not seem to be on a similar page in regards to long-run consequences. While he acknowledges the limits of predictions such as the one he is making, Schumpeter clearly sees a logical conclusion to his analysis: the very success of capitalism has a good chance of being its own undoing, as the demand for government it incentivizes for members of society must ultimately pose a threat to the ability of entrepreneurs to innovate. Cowen, by contrast, perhaps because he is specifically assuming an existing demand for

government, is far less pessimistic, or at least less certain, in his conclusions. Continued technological improvements may either increase or decrease government intervention, but there seems to be no reason to think that increased intervention will cause the entire system to completely collapse (Cowen 20). Improved technology occasionally has the habit of correcting asymmetric information in such a way as to make markets a more viable solution where it was not previously. Here, one may think of the ridesharing industry, which utilizes a simple app and allows drivers and riders to rate each other, giving people access to a knowledge source that increases the likelihood of a pleasant experience that did not previously exist in the taxicab industry even with government intervention. Conversely, technology may serve government's growth by lowering the cost of monitoring. As we move to an economy that is increasingly digital, it actually becomes far easier for a small number of government agents to monitor and regulate a larger number of transactions by utilizing algorithms to sift through the data that is automatically collected. Cowen not only wishes to caution against the predictive power of his model, he completely parts from Schumpeter's interest in the long-term consequences.

One may be inclined to retort that there seems to be a very important point upon which Schumpeter and Cowen agree: inequality plays a role. After all, if Cowen identifies any source of potential demand for government, it is that voting for increased government expenditure is a way to assuage our guilt for having more than others (perhaps because we feel 'lucky' instead of deserving) (Cowen 10). How is this so different from Schumpeter's claim that it is the inequality specifically felt in the short term that causes us to demand some sort of change? The reply is that Cowen is not really talking about the same kind of inequality that Schumpeter is, and further, it does not play the same role.

In an article for *The American Interest*, Cowen is very clear that he considers most definitions of inequality rather meaningless, as Americans enjoy a greater sense of absolute wealth than they ever have before, even suggesting that our financial system's penchant for risk is based on the fact that a major loss, economically speaking, still leaves the system in better shape than it has known through most of history ("The Inequality that Matters"). But more importantly, despite the public intellectuals bleating of income gaps, Cowen believes that most American also realize that they are better off than ever before, and so such insecurity over income gaps is not a real threat to political and economic stability ("Inequality"). Cowen sees inequality and poverty in absolute terms. In short, we may ask for more government along with our growth because we feel a little guilty about being the winners, we are generally aware enough to know that we can't throw the baby out with the bathwater. This is directly antithetical to the definition and role inequality plays for Schumpeter, who clearly believes that the common citizen cannot help but be more concerned about short-term inequality and "unfair" outcomes, as he lacks the ability to take a "big picture" view of what the system has granted him (Schumpeter 145). Inequality will always be relative only in the present sense. Additionally, the intellectual, or pundit, class which Cowen quickly brushes aside plays the central role of organizing and coalescing this discontentment into something which it can use for political gain (Schumpeter 153). This distinction in definitions of inequality is important, as Schumpeter predicts many of the outcomes he does specifically because of the assumption he holds about people's time preferences of equality. Assume people are able to grasp the long term well enough, as Cowen does, and Schumpeter's world becomes far less probable.

One may also counter that, even if Cowen is not presuming a Schumpeterian framework, his analysis has the potential to actually play a role in supporting Schumpeter's argument.

Schumpeter claims that the bourgeois culture was both a hindrance to economic growth and, paradoxically, a defense against threats to the system of growth (Schumpeter 150). The spread of new ideas certainly seems to have played some role in that change, and McCloskey contends that if Schumpeter fails, it is because he undervalues shifts in rhetoric in his theory (McCloskey 2). Surely the technological innovation that Cowen discusses making it possible for government units to communicate more efficiently also allows ideas to spread in unprecedented ways. This seems to be the case, but it still requires the intellectual to harness the technology and use it to organize their voting bloc in a politically useful way. The ideas would spread regardless, it is merely a question of time and ease.

Short View Agreement, Long View Divergence

At a blush, there is good reason for our casual Mount Pelerin attendee to assume that Cowen's argument assumes Schumpeter in the background. Indeed, when focusing on the short-term analysis, both theories predict that government will grow precisely because our real incomes are increasing and, well, we *want* more government, at least in the aggregate. In the long view, however, the author's theories diverge greatly in their predictions due to a fundamental disagreement as to *why* we demand a larger government. For Cowen, the matter is that we simply have always demanded larger government. For Schumpeter, our demand for more government arises, almost tragically, from the influences capitalism has on our other social institutions. Ultimately, this is why Schumpeter predicts a spiral toward socialism, while Cowen sees no reason for such panic.

The consequences of who is more correct is an important one. If Schumpeter is correct, specifically regarding most people's inability to view the long run, then there really is not much to be done. There is no good way of making a tradeoff between growth and equality, given what

we know to be true of political institutions. If Cowen proves to be more correct, however, then it is less clear that government growth is inevitable. Even if Cowen is correct that society has historically had a relatively high demand for government, there is no obvious reason that may hold in the future. There are, it would appear, substitutes for large government. In some cases, it may be possible that the technology that increases the supply of government possible may also work to improve the quality of market solutions in people's lives, as Foldvary and Klein have suggested. Alternatively, making people aware of the possibility of private self-governance solutions described by Ostrom may very well cause a reorganizing of preferences that decreases the demand for government and an increase in the demand for such governance solutions, although this is a question of awareness instead of technology. It is not likely that any new technology that emerges will have a larger marginal impact on these localized institutions compared to the larger scope of government. But it is still possible that people's unawareness is currently a barrier that makes a direct comparison of possibilities impossible and thus tend people toward preferences they may not have with more information. After all, a child may be perfectly content demanding more donuts with sprinkles until she discovers that there are other donuts out there that are potentially tastier.

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