"Is Inequality Harmful for Growth"

Dr. Walter Block
Harold E. Wirth Eminent Scholar Endowed Chair in Economics
6363 St. Charles Avenue, Box 15, Miller 321
College of Business Administration
Loyola University New Orleans
New Orleans, LA 70118
www.cba.loyno.edu
work: (504) 864-7934
secy: (504) 864-7944
fax: (504) 864-7970
wblock@loyno.edu

Synopsis:

Some economic commentators claim that inequality of wealth or income reduces economic development and growth of GDP. But this is counterintuitive, since economic breakthroughs usually occur by dint of great effort, or discovery, or invention, which brings great wealth to those responsible (think Bill Gates). Nor is this thesis supported by a proper interpretation of the facts of the matter, despite the contentions of several authors in this regard.

Is Inequality Harmful for Growth

Torsten Persson and Guido Tabellini (1994) (hence, PT) have an interesting thesis. It is that inequality is harmful for economic growth. That is, ceteris paribus, the more equal is the income or wealth distribution, the better are a country's prospects for economic development[1].

At first blush this is an extremely counterintuitive notion. When one thinks of economic development in the 19th and early 20th century, for example, such names as Rockefeller, Ford, Chrysler, Morgan, Hill, Pratt, Whitney, immediately leap to mind. In the more modern era, no one can speak of new products, innovations, techniques, technologies that have had an important effect on our standards of living without mentioning people like Michael Milken, Ray Kroc, Steve Jobs, Ted Turner, Bill Gates and Sam Walton. It simply cannot be denied that these men were in the forefront of economic growth, and vastly disproportionately responsible for what success we have had in this regard.

But if there is any one thing commonly and correctly associated with them, it is <u>not</u> equality. It is, rather, inequality, of the most extreme sort, since these were (and/or are) all very wealthy individuals. Nor should this be any accident. We grow by fits and starts, by leaps and bounds. Behind every large forward thrust, usually, is a risk taking, path breaking entrepreneur, who invariably reaps a vast fortune as a reward for his success. As a result it would appear that inequality, not equality, would be the earmark of a healthy, growing vibrant economy[2].

But we need not resort to historical example to see the counter intuitivity of the PT thesis. All we need do is imagine a world populated by individuals with identical skills, tastes, habits, human capital, etc. Such a world would tend to be very equal in terms of income distribution[3], but would it grow very quickly? Not likely, at least to the extent that a division of labor, specialization, and the widespread extent of trade and the market lead to development. This is because with little or no variability in the human capital stock, an economy could not avail itself of these advantages.

The PT thesis is a puzzler for another reason too. Equality may arise as a result of two very different forces. The first possibility is a limited variation of original talent -- which we discussed above. This comes about, of course, as a result of the homogeneity of the population.[4] Suppose that all or most of the people in a given country fall within a very narrow range of market productivity. While this may be expected to slow down the growth rate somewhat -- at least based on our hypothesis that growth is the result of entrepreneurial breakthroughs made by a very few powerful economic actors -- it should only retard it moderately. This is because there are many other factors which impinge upon economic development which are not intimately related to the upper tail of the abilities distribution: savings rate, stick-to-it-iveness of the populace, low taste for leisure, peacefulness (ability to get along with one another without fighting), human capital, etc.

Sowell's research (1975, 1976, 1981, 1983, 1984, 1994) points to another reason why the homogeneity that leads to wealth and income equality will also tend to stifle economic development: national groupings tend to specialize within narrow job specifications. For example, Germans tend to be good farmers, Italians concentrate on leather goods industries, Jews on textiles and finance, French on fine cooking, etc. If all or most people in a (low income disparity) country do much the same thing well, and other tasks relatively poorly, the scope for growth is thereby lessened.

However, equality can come about for a second, very different reason: not equal talents but forced income redistribution. But we all know the results of the high marginal tax rates required for any serious wealth transfers from rich to poor (Browning and Johnson, 1984; Buchanan, 1984; Buchanan and Brennan, 1980). The emigration of such as Bjorn Borg and Ingemar Bergman from

Sweden are only the tips of that particular iceberg; the most productive elements of society either put forth less effort, or leave the country entirely, seeking less egalitarian fields abroad, and or spend an inordinate amount of the treasure not in wealth creation, but in tax evasion and avoidance.

If forcibly expropriating the hard earned money of the wealthy classes cannot be expected to promote economic growth[5], neither will the effects of this policy on the poorer recipients[6] of the redistribution hold out much hope for such an eventuality. According to critics such as Murray (1984, 1990) for the domestic variety, and Bauer (1957, 1981, 1982, 1984, 1987) for the foreign, the effect of welfare on the lower classes is also counterproductive. It leads to less work effort on their part (Anderson and Block, 1993), and to all sorts of indicators of social disarray such as illegitimacy, family breakdowns, crime, etc. Much foreign "aid" goes for the 3 M's: monuments (whether in the form of statues extolling the virtues of the dictator, or needless economic white elephants such as an uneconomical steel factory, or national airline), Mercedes (for the dictator and his close minions to ride around in, surveying the harm they have done to the economy), and machine guns (the better to safeguard their continued power).

Robbing Peter and giving the proceeds to Paul does not help <u>either</u> of them to contribute to economic growth.

One might reply to this charge of counterintuitivity that the facts don't lie: the result of PT's empirical analysis is that inequality is <u>negatively</u> and statistically significantly related to growth. There are two possible rejoinders to this response. First, there is nothing counterintuitive about growth and equality having a positive relationship to one another provided that the source of the latter is homogeneity of talents and productivity[7], not forced redistribution. It is perhaps less likely that this would take place than would the opposite -- heterogeneity of ability makes for a greater division of labor and hence more gains from internal trade -- but such a conclusion would at least not be incompatible with what we know to be the effects of compulsory tax takings.

To be sure, PT do attempt to control for this possibility. They do so with their variable, SCHOOL, but we suggest that this is at best a very imperfect proxy for the underlying differentials in potential ability.

Another difficulty is that their findings positively invite a reinterpretation. They report a significant and positive association between income equality and growth. They interpret this as support for redistribution of income and wealth, given the goal of economic development. But this need not follow. Based on their findings, one could with equal logic support a program of kicking foreigners out of the country, and preventing new ones from coming in. This would be true if the pro growth aspects of homogeneity (less strife) outweigh the anti growth ones (loss of division of labor, etc.).

Let us consider in closing some of the causal interactions, and empirical relations, between inequality and economic growth on an international level, so as to transcend what might otherwise be considered exploration of mere ceteris paribus relationships[8]. According to Gwartney, Lawson and Block (1996, table S-3, p. xxiii) between the years 1980-1994 Hong Kong (5.0%) and Singapore (5.3%) experienced amongst the highest rates of GDP growth in the world, while that of Canada (1.3%) and Germany (1.8%) were far more modest. And yet, the latter two countries are noted for high top marginal tax rates (Germany, 53-56%; Canada, 43-54%) in the 1990s, while the former pair are characterized by the exact opposite state of affairs (Hong Kong, 25%; Singapore, 30-33%) during the period of time.[9] This allows for relatively small transfers of funds from the rich to the poor, indicating less income equality, in the high growth Hong Kong and Singapore, and relatively more in the low growth Canada and Germany. If income equality unambiguously led to greater income growth, we would expect to encounter the very opposite state of affairs.

Another way to look at this issue is the following. Ethics is an exogenous force in the socioeconomics or political economy of income growth[10]. It is unethical to steal. This applies not only between individuals, but to groups as well. If two robbers break into my home and attempt to steal my t.v. set, they are no more justified than they otherwise would be in this act just because they can "vote" against me by a two to one margin. The same analysis also applies to nations[11]. Just because most of the electorate supports forced equality through rapacious taxation levels, and exorbitant top marginal tax rates, does not convert that which is unethical into something that is ethical. But the realm of morality is not unconnected to that of economics. Normative and positive economics may be two different arenas of discourse, but they are related. A recent incidence of this phenomenon is the "brain drain" afflicting Canada, as its "best and brightest" citizens flock to the country to the south of them in search of a less greedy tax regime. For the decade of the 1990s, Gwartney, Lawson and Block (1996, pp. 128, 220) award the U.S. tax system 7 out of a possible 10 points (10 implies an approach to laissez faire capitalism, a 0 suggests the very opposite end of the spectrum, toward socialism and interventionism), and the Canadian 4.5

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Footnotes

1.The thesis of these authors has been characterized as follows by Professor Robert A. Lawson of Capital University (personal correspondence, dated 11/3/99): "In unconstrained democracies, income inequality fosters the creation of distributional coalitions that lead to the enactment of growth-reducing legislation. Indeed, they suggest that the negative effects of the distributional coalitions will outweigh the positive effects of allowing inequality (i.e., incentives to work, innovate, etc.)." He goes on to criticize this thesis as follows: "If true, reducing inequality in these democracies would increase growth. The real problem, though, is not inequality as such but rather unconstrained democratic rule. Income inequality only exerts a negative influence on growth through the political process. Fixing the political process (i.e., constraining it) as opposed to reducing inequality would thus be a more effective way to enhance growth."

2. True, these economic benefactors have enriched literally an entire society with their creativity. Thus, while their personal wealth grew in absolute terms, this effect was less strong relative to the economic status of others. In contrast, when a dictator seizes the wealth of millions, he enriches himself while impoverishing them. In this way the income distribution of a nation with a strong political class comes to be more unequal than one with a strong entrepreneurial class. The second works in a positive sum mileau, while the first functions in a zero sum climate.

But it would be a mistake to conclude from the foregoing that the captains of industry are not a force for inequality. They are. All that can be garnered from this example is that kings, rulers and military strong men are even more of a force for inequality than are successful men of business.

3. What could mar that result except divergences in pure luck and in the different ages of the people involved?

4. Candidates for real world examples of this phenomenon would include, particularly, Iceland, Korea, Japan, Sweden, and others in which immigrants constitute a very small proportion of the population.

5. Here, we assume that the income of the rich was derived through markets, or through what (Oppenheimer, 1914) has called the "economic means." That is to say, that by becoming rich, these people enriched the society as a whole. This is in sharp contrast to what (Oppenheimer, 1914) has called the "political means." In this case the wealthy achieved that status not by market activity, but through forcibly seizing others property.

6. Here we assume, just for the sake of argument, that the actual (as opposed to the presumably intended) effect of the wealth redistribution will be, on net balance, from rich to poor, and not the other way around. This, too, is somewhat counterintuitive, once it is realized that those who are wealthy are likely than the poor to be more able to "work" the political process in their own favor.

7. Subject, of course, to disclaimers mentioned above.

8. I owe this emphasis to an anonymous referee of this journal.

9.Gwartney, Lawson and Block (1996); for Germany, p. 144, Canada, p. 128; Hong Kong, p. 154, Singapore, p. 196.

10. This point was forcefully made by an anonymous referee of this journal.

11. For a critique of governmental transfers of funds through taxes and subsidies in order to promote income or wealth equality, see Block (1990), Rothbard (1997).