Update: The Relationship Between Inequality, Economic Systems and Economic Growth

By John Goodman - 6/4/23

All economic historians accept the hockey stick description of human progress.

The Hockey Stick

From the beginning of modern humans on earth (roughly 200,00 to 300,000 years ago) until about two and a half centuries ago, our ancestors were incredibly equal in terms of material wellbeing.

Except for an occasional king or queen, virtually everyone lived at the subsistence level. Economists describe that as the rough modern equivalent of living on $2 a day. As Prof. Landsburg explains, if you were really lucky you might have had the fortune to live in a place and time when you had the equivalent of $3 a day. If you were really, really lucky you may have had as much as $4 a day. But that was pretty much it.

Imagine what life would be like today if all you had to secure food, clothing and shelter was $2 to spend every day. That was how your ancestors lived for several hundred thousand years.

Then, about the middle of the 18th century, in what we now call the "developed world," things began to change. And they changed very rapidly.

> Here is George Mason University economist Don Boudreaux's video explanation of the hockey stick.
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> Here is university of Rochester economist Steven Landsburg's video explanation of the hockey stick.
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> Here is SMU economist Michael Cox's video description of how progress has continued in the US throughout the 20th and 21st centuries.

Why Did This Happen?

According to Adam Smith, the father of economics, nations become wealthy when they respect private property rights and allow free exchange. In such an environment, people find it in their self-interest to meet the needs of others. The more needs they meet and the more successfully they meet them, the more prosperous they will become.

In the *Wealth of Nations*, Smith famously wrote;

> It is not from the benevolence (kindness) of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest.

Smith wrote those words in 1776. But according to Deirdre McCloskey, the explanation still holds true today – although she maintains that the culture of capitalism is perhaps more important than capitalism itself.

An explanation of how international markets connect people all over the world and make the self-interest of each of us tied to the self-interest of others is illustrated in the video, I Pencil.

What About the Less Developed World?

For a very long time, large sectors of the world were not part of the international market economy. As recently as three decades ago, one-third of all the people in the world were in extreme poverty – living pretty much at the same level of subsistence their ancestors experienced for tens of thousands of years.

Within the last 30 years, however, these areas (especially China and India) began welcoming foreign investment, protecting private property rights and engaging in international trade. In a word, they became part of the international capitalist system. The resulting change has been remarkable.

The New York Times explains:

> In 1990, about 36 percent of the global population — and nearly half of people in developing countries — lived on

less than $1.25 a day, the World Bank's definition of extreme poverty at the time. (It's now $1.90 a day.)

By 2015, the share of the world's population living in extreme poverty fell to 12 percent from 36 percent in 1990, a steep decline in just two and a half decades. **During a single generation, more than a billion people around the world climbed out of extreme poverty.**

Capitalism and Inequality

Since the engine that drives a market economy is the financial reward for meeting the needs of others, and since in a complex system there is no way those rewards will be enjoyed equally, it is inevitable that in a market economy there will be a lot more inequality that there was when everyone was living on the edge of subsistence.

So, here is one question: Is the inequality produced by a market economy acceptable because everyone will have more than a subsistence-level income?

For the vast majority of people in the world today the answer is unequivocally yes. That is why there is so much immigration and attempted immigration from socialist to capitalist countries and almost never immigration in the reverse direction.

The second question is: If reducing the inequality in a market economy results in less income in the aggregate (Arthur Okun's Leaky Bucket Theorem), how much of their income are people willing to sacrifice to achieve that goal?

Through the years there have been a number of polls asking people how much of their personal income they would be willing to sacrifice to achieve various egalitarian goals. The answer is generally: very little.

The latest poll on health insurance asked how much people would be willing to pay in extra taxes to insure the uninsured. Thirty percent preferred to pay nothing. Among the remaining 70 percent, the willingness topped out at $50 per year.

By way of contrast, the cost of Obamacare is equal to $1,683 per year per U.S. household. That suggests that people would never vote for Obamacare if they knew how much their share of the cost really is.

What about Socialism?

In the 20th century socialism was enamored by the left and a number of countries set up entire systems based on the idea. Communism was established in the Soviet Union, China, Cuba and North Korea. National socialism (what most people today call fascism) was established in Germany and Italy.

It was not a pretty picture. In the 20th century, an estimated 169 million people were killed by their own governments. It was genocide on an unimaginable scale. The vast majority of these victims were murdered by socialist governments. The Russian communists were the worst (62 million) followed by the Chinese communists (35 million) and then the Nazis (20 million).

Of those countries, only two today (North Korea and Cuba) are still trying to force a socialist economy on their populations. However, they have now been joined by Venezuela, and other Latin American countries may follow suit.

Socialism seems to have two appeals. One is the altruistic idea that people should live for others and not pursue their own self-interest. The other (especially in the communist countries) is the idea that the benefits of economic progress should be shared equally.

Yet despite the rhetoric about equal consumption, socialist societies have turned out to be the most unequal societies found anywhere in the world.

These and other important things to know about socialist economics are summarized in my Essay on Socialism.

What about the Scandinavian Countries?

From time to time both politicians and scholars have pointed to Europe – especially northern Europe – as examples we should emulate. Sometimes the Scandinavian countries are even referred to as "socialist."

Yet, as any head of state of any Scandinavian country will quickly tell you, their countries are not socialist. They are capitalist. In many ways they are more capitalistic than we are. For example, in Sweden, Norway and Denmark there is no minimum wage law. These three countries are also rated as among the easiest countries in the world to do business in.

Most Nordic countries have no estate tax. Sweden has a country-wide school voucher program – with freedom of choice for parents and their children to choose among public schools, private schools and even for-profit schools.

What the Scandinavian countries have more of is social insurance: more health care, more retirement benefits, etc. But these benefits are mainly paid for by higher taxes on the middle class – the very people who expect to benefit – not by taxes on the rich.

The U.S. does have a more unequal distribution of income than most European countries. However, that is not because of government redistribution in Europe. As noted, a very careful study shows that the U.S. redistributes more income from the top to the bottom of the income ladder than just about any other developed country.

European countries have more equality of income distribution because pre-tax incomes are more equal, not because government redistributes more.

[Although not a conclusion of the study, my own opinion is that the populations of European countries tend to be more homogeneous. People who are very much alike tend to have financial outcomes that are alike. The U.S., by contrast, is a very heterogenous “melting pot.” It is normal to expect that heterogeneous populations would produce heterogenous financial outcomes.

That said, within the last decade there has been considerable migration from northern Africa to Europe – because of war, famine and poverty. This immigration is bringing to Europe people with very different cultures and very different religious beliefs. Because of this inflow, the populations of European countries are becoming more heterogenous and I suspect that will lead to a lot more inequality than we have seen in the past.]

The Easter Egg Hunt Analogy

Imagine a children’s Easter egg hunt. Before the exercise begins, all the children are equally poor. No one has an egg. Then, as a result of the hunt, many eggs are found. Random chance alone assures that the spoils of the hunt will not be shared equally, however. After searching and gathering, some children will have more eggs than others.

Allowing each child to pursue his or her own interests leads to an increase in the children's collective (egg) wealth. But that wealth will almost certainly be distributed unequally.

Now suppose we have a rule that dictates the following: after the hunt is over, all the eggs will be confiscated and divided equally among all the children.

In the face of that rule, each child has a reduced incentive to search as long or as hard. In fact, many children will see no reason to search at all. They will get almost no personal benefit from finding one more egg – since that egg will be shared equally with all the other children.

The result: fewer eggs will be found and the children's collective (egg) wealth will be lower. Maybe a lot lower.

A Real Story: Jamestown

In the very first permanent English settlement in North America, there initially was no private ownership of the means of production. That meant there was no connection between how much people worked and how much they consumed.
The result? Something approaching mass starvation.

In 1609, there were 500 settlers. Within six months, fewer than 100 were still alive. People were desperate. They ate dogs and cats, then rats and mice. Some apparently ate their deceased neighbors.

Then, with a new governor in charge, they created private property. David Boaz writes:

> John Rolfe, the husband of Pocahontas, said that once private property was instituted, men could engage in "gathering and reaping the fruits of their labors with much joy and comfort." The Jamestown colony became a success, and people from all over Europe flocked to America.