Inequality, (Transaction) Costs & Choice

VINCENT GELOSO
Bates College

Email: vincentgeloso@hotmail.com
Web: https://vincentgeloso.com

There is such a thing as "good inequality". After all, a Benedictine monk and a hedge fund banker have important income differences (and the differences are probably growing over time). Yet it is unlikely that the monk would be willing to accept the banker's job at the level of income the latter earns. While this is an extreme example, it suggests that the maximization of one's well-being may not be perfectly expressed by the maximization of income. In fact, the more it becomes possible for individuals to seek satisfaction on other, more heterogenous, planes of existence, income inequality will speak less efficiently of inequality in well-being. One should consider the following fact if one is skeptical of the relevance of this *reductio ad absurdum:* while income inequality has been increasing in western societies, inequality in life satisfaction has been *falling* (Stevenson and Wolfers 2008; Clark et al. 2014; 2016). Elsewhere, I have pointed out that there are other forms of "good" or at the very least "neutral" inequality such as immigration and demographic changes (Geloso and Horwitz 2017).

However, if there are "good" inequalities, there must also be "bad" inequalities. In her book, Novak (2018) is concerned with the "bad" inequalities of which there are two kinds. There are those that result from birth—the "sticky" inequality as Corak (2013) puts it. There are also those that result from institutional decisions which either weigh down the poor or push up the rich. The latter kind of inequality is the one that Novak deals with.

Essentially, she uses the rich approach developed by Richard Wagner (see Smith, Wagner and Yandle 2011 for a good summary)—the entangled political economy approach—to explain that inequality *must* be decomposed by sources. Each source of inequality is the result of a particular institutional setting which reverberates with other institutional settings. In a way, she argues that we ought to study the ecology of inequality where the word ecology refers to institutions. All these efforts are undertaken to provide a classical liberal answer to the daunting topic of inequality.

There is much to commend in this approach, namely for the fact that it actually pays (much) more than the usual lip service to the role of institutions. For that reason alone, the book should be considered an important contribution to the debates on inequality. This does not make the book flawless. There is the need to differentiate the analysis made by Novak from the classical liberal answer to inequality she wishes to provide. To be transparent, I am a classical liberal. However, this only comes third in the ranking of what I believe defines me, after being an economist and being a cliometrician. As such, I feel the urge to separate my view of inequality as a classical liberal and my view of inequality as an economist and cliometrician. The two are not necessarily antagonistic, but they are dramatically different.

This symposium article argues that an economics case should be made separately from the classical liberal case. The main reason is that that the economics case is superior on three fronts.

The first is that measurements matter inasmuch as they affect the stylized facts regarding inequality. In her book, Novak accepts too readily the existing state of empirical evidence. The second is that transaction costs, which have often been ignored in the economics of inequality literature, are crucial to understanding inequality and the institutions that generate it. The third is that inequality *does* bear real economic costs—something which is not sufficiently emphasized by Novak.

All of these advantages provide make the economics case superior to the classical liberal case. This is because the economics case can *serve* the classical liberal *as well* as it can serve other ideological worldviews.

I. ON MEASUREMENT AND THEORY

I feel that Novak accepts too readily the inequality figures proposed by many. On many pages, she casually refers to the evidence available and mentions timidly works like those of Auten and Splinter (2017) who show that the increase in inequality since the 1970s has been over-estimated in seminal papers such as Piketty and Saez (2003).

However, there are a great array of reasons to question the state of the empirical evidence. This is because inequality is a topic like no other within the field of economics. Generally, economists start from axioms which are invariably true and thus lead to a predominantly inductive approach. What applied economists do is assess the relevance of a particular axiom (which may be competing with another) to a given situation. For example, the theory of asymmetric information is axiomatically true. The prediction is that this should lead to a "market of lemons" (Akerlof 1970). However, theories about signaling suggest that this issue can be easily overcome making it more or less irrelevant to the real world (Bond 1982). Inequality is not like those topics as most of the theorizing is deductive. Patterns and levels of inequality are observed and *then* theories to explain them are derived. In a predominantly deductive field, all discussions must start with data.

One of the most heralded "facts" of the economics of inequality literature is that there is U-Curve of income inequality over the 20th century (Piketty and Saez 2003; Piketty et al. 2017; Lindert and Williamson 2016). While that pattern appears shared for many countries, it seemed more pronounced in the United States. From high levels in the early 20th century, inequality fell in "great leveling" (Lindert and Williamson 2016) up to the 1970s. From that lower level, inequality has surged to the present day, reaching levels equal to those in the beginning of the 20th century. On this empirical narrative, many have grafted political theories. The 1920s were decades of limited income redistribution and regulation. Thus, inequality was high then. Up to the 1970s, the growing arm of the state led to increased redistribution, more regulation (notably those allowing unions to bargain for better working conditions) and higher taxes on the wealthy. Thus, inequality fell in that period. Thereafter, with deregulation and tax cuts, inequality rose again. The empirical evidence serves a political economy argument rather than the reverse.

Yet, there is evidence that the shape is not as pronounced for the United States. Indeed, Mechling et al. (2017), Auten and Splinter (2017) and Magness (2018) have shown that the sources used to measure inequality have important biases. The most-used sources come from tax records which are, evidently, responsive to tax policy. The latter two studies show that when corporate taxes were lower than income taxes, individuals shifted income sources to the former. When tax reforms inverted this relation, the opposite movement was seen. This meant that, when income taxes became inferior to corporate taxes, individuals shifted their incomes to the less-taxed avenues and would have meant an artificial increase in "individual income". Correcting for this effect, the two studies show a dramatically lower level of inequality post-1970 and a more timid increase. The right side of the "U-Curve" is not too robust. Then, on the left side of the U-Curve (pre-1945), Geloso et al. (2018)—echoing Smiley (1983; 2000)—have shown that there are similar data issues leading to an overstatement of inequality in the 1920s and to a less pronounced fall from the 1920s to the 1970s. When the two critical literatures are mixed, inequality does seem to follow a curvilinear function over time, but it looks more like a tea-saucer than it does a U-Curve.

Why are these elements relevant? Because the smaller movements can be interpreted with basic economic theory. For example, between the late 19th century and the mid-20th century, the different regions of the United States became more economically integrated so that income differences across regions lessened importantly (Michener and McLean 1999; Lindert and Williamson 2016; Ganong and Shoag 2017; Klein 2013; Geloso 2018). This convergence, which is also observed in countries like Canada (Emery and Levitt 2002) and the United Kingdom, can be explained within a simple Solow-growth model: capital moved from the rich northeastern states to the poorer southern states (Turner et al. 2013) and workers, most notably African Americans (Boustan 2016), moved in the opposite direction. This simple mechanism, given that the fall in inequality is much smaller than previously believed (assuming one believes the findings of Geloso et al. 2018), explains a large share of the reduction in inequality to the 1970s. It also explains a small share of the increase since the 1970s as there has been widening income differences *between* states since the 1970s. (Ganong and Shoag 2016; Geloso 2018).

The more modest the shape of the U-Curve becomes, the more potent alternative explanations of its evolution become. Consider two examples for the increase: aging and the prison population.

With regards to an aging population, it has long been known that because income is in part a function of age (and so is wealth), a changing demographic structure will *by definition* affect the level of inequality even though all incomes may increase equally (Paglin 1975). Some studies, although they do not consider the American case, point out that aging explains a sizable share of the evolution of inequality (Almas and Mogstad 2011). Taking this empirical fact into account alters the deductions to be made from the facts, making it harder to graft a political narrative on the empirical facts.

The case of the war on drugs is also telling. As a growing share of the American population is either in a correctional facility or in the wider American judicial system (probation etc.) and that criminal records flatten the evolution and the level of one's income, it is logical to say that a growing segment of the American population boasts a scar from prison. As this segment is growing, it is also a logical conclusion that inequality must be growing. If the increase in inequality as measured by tax data (generally the norm) is more modest, then the effect of incarceration may boast a stronger role in explaining it than re-distributive policies. In fact, simple data sampling may be at play (but which means that we are *understating* inequality). The population who goes to jail is not randomly distributed. The likelihood of going to jail is highly correlated with low socioeconomic status. As such, when surveys of workers are taken whilst the prison population grows, the surveys are "cream-skimming" the richest workers. When scholars like Bruce Western and Becky Pettit (2005) corrected for this sampling bias issue, they found that the gap between Black Americans and the rest of Americans is wider and growing wider. It stands to reason that this means greater inequality.

All these are merely examples in order to show how important empirical issues can be. As the inequality debate is largely a deductive one, the quality of the empirical facts matters considerably in assessing explanations. This is why the economics case has the upper hand, it can serve to *interpret* the movements. The classical liberal case made by Novak is unconcerned by the level and trends, it is merely concerned with explaining them and takes them for granted. While this may be a conceptually richer approach to develop a theory, it will most likely fail to engage those who are engaged in the current discussions of inequality.

II. (TRANSACTION) COSTS & CHOICE

The second advantage to an economics approach is that the deductive nature of the economics of inequality debates can be assailed by simple deductions drawn from economic theory. One such theory is that of transaction costs. Simply put, transaction costs are the costs we bear to make exchanges. They prevent us from seeking enrichment through trade with another. Anything that reduces them leads to improvements in living standards. However, all costs are purely subjective (Buchanan 1978). This is because the transaction costs are specific to individuals *and* specific exchanges. There is not *one* transaction cost. There are many different transaction costs as there are exchanges available to each individual. Transaction costs associated with a particular exchange may be higher for individual A than it is for individual B.

This seemingly benign observation is rife with implications regarding inequality and institutions. The most important one is that since *all costs* are subjective, individuals may maximize their well-being in a variety of ways. In fact, the more heterogeneous and numerous the options to maximize subjective well-being become, the likelier it is that inequality as measured by income will increase. Rich societies offer more heterogenous ways to life a satisfying existence in ways that incomes are poor synonyms. This would explain why income inequality is increasing while life satisfaction inequality is falling as noted in the introduction. It is hard to frown upon such inequality within the framework of the most elementary principles of microeconomics.

Another implication is that individuals similar to A (those with low transaction costs) will find it easier to truck, barter and exchange. Those individuals will be better off and there are no implications for individuals who are like B. As such, there may be higher and growing levels of inequality in that setting, but it is hard to defend the claim that inequality is harmful.

The most important implication however is that individuals who are akin to A may associate to lobby for institutional settings that redistribute from the Bs to themselves. Their lower transaction costs enable them to trade as much as it enables them to organize politically and request edicts and laws that benefit them at the expense of others.

Randall Holcombe (2018) has provided a simple (but rich) elaboration on this insight. Those whose comparative advantage, because of lower transaction costs, lay in political action will engage in rent-seeking and redistribution of income towards themselves. The institutional rules are shaped by *their* transaction costs (under the premise that the returns to trade are inferior to the returns from rent-seeking). This will unavoidably lead to inequality. However, this inequality is noxious because it results from a specialization in rent-seeking. It is not the inequality per se which is noxious.

To be fair, Novak gets this logic as observed by her chapter on constitutions and constraints that exist to prevent political exchanges from occurring between those rent-seekers and those whose transaction costs (note: the answer always involves transaction costs, regardless of the question asked) make them comparatively better in the world of politics. In words different than those used here, she makes the same point. To be even fairer, her point is one that few economists properly appreciate. Embedded inside the entangled political economy framework, its analytical potency is so great that it boggles my mind that so few economists have not realized this value. However, she enlaces this strong point within her view of liberalism. This, as we will see below, leads to a) an understatement and incorrect analysis of the costs of inequality and b) a reduction of the ability to convince those inimical to classical liberalism.

III. THE COSTS OF INEQUALITY

The individuals who organize to extract rents from individuals less able to overcome the costs of organizing will generate inequality. This inequality *can be* heavily detrimental to growth and development because it changes the costs of exchange in the process.

Consider the argument made by Samuel Bowles (2012) who provides the most interesting proposal for why inequality is hurtful to growth. Because inequality drives individuals further apart in socioeconomic conditions, it creates social distance between such individuals. Lack of trust is, in Bowles' logic, likened to a principal-agent problem. Because they are so different, the richer individual is unable to conceive the behavior of the poorer individual who happens to work for him and, as such, he mistrusts him. He expends resources to supervise this worker. He either hires an accountant to make sure he does not swindle or a supervisor to monitor his activities. He may also hire security guards to protect his assets. This why, in a related paper, Bowles and Jayadev (2006) argue that "guard labor" (supervisory workers, security guards, forensic accounts, private detective, police officers, judges—anyone who serves to supervise others) is heavily related to inequality. These are, Bowles argues, the costs of inequality.

Elsewhere, I have disagreed with Bowles (Geloso and Kufenko 2017) on whether or not this applied to the United States (which is what he argued). But this does not make his point necessarily invalid. It is axiomatically true that the cost of guard labor is a cost we bear to exchange and if institutional settings make this cost greater, then growth is hindered. The low-wage citizenry may not be aware of the policy hurting them, but they may come to see the income differences between them and the rich as unfair if they see no way of increasing their standard of living. The inequality thus translates into mistrust which then fuels a greater demand for guard labor. This is the cost of inequality—the cost we incur after the rent-seeking to continue exchanging but which, progressively dilapidates (partially) the rents.

This cost of inequality is a direct implication of the transaction costs logic laid above. Few economists have followed this insight to its logical end. The one exception is Finis Welch (1999) who, in the American Economic Association's Richard T. Ely lecture, made a "defense of inequality." In it, he argues the following: "inequality is destructive whenever the low-wage citizenry views society as unfair, when it views effort as not worthwhile, when upward mobility is viewed as impossible or as so unlikely that its pursuit is not worthwhile." (Welch 1999 p. 2)

Not only that, but Welch also identifies the example of inequality where only low transaction costs individuals trade together. Imposing no negative externalities upon others. In fact, he even identifies that income inequality sends a signal about where returns are greatest. In other words, he says inequality sends the signal of which transaction costs are the most noxious in blocking exchanges. As such, he identifies the "benefit" of inequality. Yet, Welch is one of the very few who argues for this very rich and potent view of inequality—his *American Economic Review* article is cited a scant 226 times according to google scholar and five of these come from myself. A classical liberal argument, even if it has no inconsistencies such as Novak's, holds even less potential than that of Welch. This is in part because a classical liberal argument downplays the true costs of inequality. It is far more likely that, if advanced rigorously, an expansion upon Welch's argument may convince more.

IV. LIBERALISM AND OTHERS

I am back against the classical liberal angle because it prioritizes destination over direction. As I confessed earlier in this article, I consider myself part of the classical liberal tradition. However, I do wish to speak to those who do not share my inclination since they may want to go in the same direction as myself. The economics argument, by virtue of being universal, speaks to them and may serve to create a common path.

If social-democrats adopt portions of the economics argument made here and push for policies that ease constraints upon the upwards mobility of the least well-off, then they will walk in the same direction as classical liberals. If multiculturalists adopt the view that the heterogeneity of preferences spawned in a rich society mean that inequalities of income are bound to exist but be meaningless in terms of human well-being, they will tolerate higher aggregate levels of inequality because they reflect the true diversity of society. As such, they follow in the same direction as the classical liberals. If conservatives accept that "natural" (Kirk 1953) inequalities are not so "natural" but sometimes the outcome of rent-seeking individuals who have a comparative advantage in shaping rules to their advantage, then they will push for measures that will make them walk in the same direction as the classical liberals.

The point is that an economics explanation, while it speaks to liberalism, has a universal appeal. It is not antagonistic to the classical liberal view, it is merely a good servant for all views.

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