

ARTHUR OKUN: EQUALITY & EFFICIENCY: THE BIG TRADEOFF

CHAPTER FOUR

Increasing Equality in an Efficient Economy

THIS ESSAY began with a visit to the domain of social and political rights in which society gives priority, at least in principle, to equality over economic efficiency. It moved into the marketplace and other economic institutions, in which efficiency gets priority and a large degree of inequality is accepted. It then inspected a few bright prospects for increasing economic efficiency and equality simultaneously. Those prospects are important, but they are limited. Frequently, society is obliged to trade between efficiency and equality. Those trades pose the difficult choices and they are the subject of this final chapter.

THE AREA OF COMPROMISE

If both equality and efficiency are valued, and neither takes absolute priority over the other, then, in places where they conflict, compromises ought to be struck. In such cases, some equality will be sacrificed for the sake of efficiency, and some efficiency for the sake of equality. But any sacrifice of either has to be justified as a necessary means of obtaining more of the other (or possibly of some other valued social end). In particular, social decisions that permit economic inequality must be justified as promoting economic efficiency. That proposition is not original,¹ but it is important and

1. See Lester Thurow, "Toward a Definition of Economic Justice," *Public Interest*, No. 31 (Spring 1973), p. 63. The germ of the

INCREASING EQUALITY

89

apparently remains controversial. Efficiency alone is the criterion for anyone who opposes progressive taxes because he detects *some* adverse effects on incentives. Equality gets no weight in the verdict of an economist who recommends the same formula for any and every shortage: let the price rise to its own level without government interference. At the other extreme, anyone who views high profits anywhere as a *prima facie* case for public action must be judging by equality alone.

The cartelization of the world oil market engendered a display of such pure no-tradeoff views. Free-market exponents argued the efficiency case: at a new, high, market-clearing price within the United States, curtailment of consumption and expansion of domestic production would both be encouraged. No disruptive shortages would emerge, and the limited supplies would flow to those users who needed oil most, as evidenced by their willingness to pay the most. And this argument may well have been correct, in terms of efficiency alone. But at least during the embargo, the market-clearing solution might have transferred as much as \$60 billion of income (at annual rates)—a toll of \$20 a week, for the average American family—from oil consumers to domestic oil producers. Wasn't some queuing at gas stations a lesser evil of inefficiency compared to that huge additional inequality?

On the other hand, the antiprofitteering hawks focused on eliminating the windfalls enjoyed by the producers rather than the shortages endured by the consumers. Although the embargo was instituted and the cartel price set by foreign potentates and not by American businessmen, the gains of a few corporations were resented, particularly because they accompanied the losses to most Americans. In this case, what was bad for the country was unquestionably good for Exxon.

idea can be found in Pigou; I suspect that it goes back a lot farther, but I can't trace it. This is a much weaker condition than Rawls' difference principle, discussed below.

Still, some of the measures espoused (like hefty excess-profits taxes or inflexible price freezes) would have made things less good for Exxon only by making them worse for the country.

The actual policies adopted in 1974 lay somewhere between the promarket and antiprofit positions. The price of crude oil for that part of U.S. production that had been geared up by 1972 was controlled at a ceiling of \$5.25 per barrel. Since the capability for producing such "old oil" was established and expected to be profitable when the price was \$3.50, the ceiling limited the size of windfall profits. Similarly, ceilings were set on refinery and distribution margins. On the other hand, the price of incremental crude production—"new oil"—was not controlled and soared above \$10 to the world price fixed by the cartel. In effect, the price of U.S. new oil was allowed to be set by OPEC, the organization of petroleum-exporting countries, while that of old oil was fixed by the U.S. government; neither reflected competitive forces, since the cartel had strangled competition. The case for letting new-oil prices soar rested on efficiency; the policy sought to generate enormous profit incentives for expanded domestic production. Considerations of efficiency and equality were thus blended into an imperfect compromise.

In critical areas, such compromises tend to emerge from the political process. The real question is usually one of degree. On what terms is the nation willing to trade equality for efficiency? Anyone who has passed a course in elementary economics can spout the right formal rule: promote equality up to the point where the added benefits of more equality are just matched by the added costs of greater inefficiency.

As is so often the case with the rules that are taught in basic courses, this one provides insight but is hard to apply to the real world. The consequences of most redistributive measures on both equality and efficiency are uncertain and debatable. Confronted with a proposed tax or welfare equalization, no

legislator or voter can assess how much the program would add to equality or subtract from efficiency. Thus decision-makers do not get opportunities in the real world to test neatly their priorities between the two competing objectives. But the author of a book can create a hypothetical world that suits him. And so I can propose an experiment by which you can test your attitudes toward the tradeoff.

The Leaky-Bucket Experiment ✓

First, consider the American families who make up the bottom 20 percent of the income distribution. Their after-tax incomes in 1974 were less than \$7,000, averaging about \$5,000. Now consider the top 5 percent of families in the income pyramid; they had after-tax incomes ranging upward from about \$28,000, and averaging about \$45,000. A proposal is made to levy an added tax averaging \$4,000 (about 9 percent) on the income of the affluent families in an effort to aid the low-income families.² Since the low-income group I selected has four times as many families as the affluent group, that should, in principle, finance a \$1,000 grant for the average low-income family. However, the program has an unsolved technological problem: the money must be carried from the rich to the poor in a leaky bucket. Some of it will simply disappear in transit, so the poor will not receive all the money that is taken from the rich. The average poor family will get less than \$1,000, while the average rich family gives up \$4,000.

I shall not try to measure the leak now, because I want you to decide how much leakage you would accept and still support the Tax and Transfer Equalization Act. Suppose 10 percent leaks out; that would leave \$900 for the average poor family instead of the potential \$1,000. Should society

2. As the redistribution is described here, the abrupt termination of the tax just below the top 5 percent of the distribution as well as of the transfer just above the bottom 20 percent would imply inequitable "notches." Any real-world proposal would have to smooth these out, and also to determine the proper sharing of the tax burden and transfer benefits.

still make the switch? If 50 percent leaks out? 75 percent? Even if 99 percent leaks out, the poor get a little benefit; the \$4,000 taken from the rich family will yield \$10 for each poor family. Where would you draw the line? Your answer cannot be right or wrong—any more than your favorite flavor of ice cream is right or wrong.

Of course, the leak represents an inefficiency. The inefficiencies of real-world redistribution include the adverse effects on the economic incentives of the rich and the poor, and the administrative costs of tax-collection and transfer programs. The opponent of redistribution might argue that my experiment obscures the dynamics of the incentive effects. He might contend that any success in equalization today is likely to be transitory, as the adverse impact on work and investment incentives mounts over time and ultimately harms even the poor. What leaks out, he might insist, is the water needed to irrigate the next crop. In addition, anyone who views market-determined incomes as ethically ideal rewards for contribution would oppose the switch, regardless of the size of the leak.

On the other hand, some would keep switching from rich to poor as long as anything at all remains in the bucket. That is the import of John Rawls' difference principle, which insists that "all social values . . . are to be distributed equally unless an unequal distribution of any . . . is to everyone's advantage"—in particular, to the advantage of the typical person in the least-advantaged group.³

Rawls has a clear, crisp answer: Give priority to equality. And, as he always does, Milton Friedman has a clear, crisp answer: Give priority to efficiency.⁴ My answer isn't neat. My answers rarely are, and that is one trouble I generally encounter in such ideological debates. Here, as elsewhere, I

3. John Rawls, *A Theory of Justice* (Harvard University Press, 1971), p. 62.

4. This position is clearly implied by Friedman's discussion in *Capitalism and Freedom* (University of Chicago Press, 1962), pp. 161-66, although it obviously is not addressed to my particular experiment.

compromise. I cannot accept Rawls' egalitarian difference principle. It is supposed to emerge as a consensus of people in the "original position," when they develop social rules without knowing where their own future incomes will lie on the pyramid. But, as other economists have noted,⁵ that difference principle would appeal only to people who hate to take any risk whatsoever. That is the implication of the view that no inequality is tolerable unless it raises the lowest income of the society. According to this "maximin" criterion, society is worse off if the lowest-income family loses one dollar, no matter how much everybody else in the society gains. For example, a framer of the social constitution would embrace the difference principle only if he preferred a society that guaranteed every family \$14,000 a year—no more and no less—over one that provided 99 percent of all families with \$20,000 and 1 percent with \$13,000. Put the American people in an "original position," and I certainly would not expect them to act that way.⁶

If I were in Rawls' original position, I would argue that the social constitution should not seek to settle forever the precise weighting of inequality. It should instruct the society to weight equality heavily, but it should rely on the demo-

5. See Kenneth J. Arrow, "Some Ordinalist-Utilitarian Notes on Rawls's *Theory of Justice*," *Journal of Philosophy*, Vol. 70 (May 10, 1973), pp. 245-63; and Sidney S. Alexander, "Social Evaluation Through Notional Choice," *Quarterly Journal of Economics*, Vol. 88 (November 1974), pp. 597-624.

6. I do believe that risk aversion encourages preferences for equality. In my view, Rawls' original position provides a better framework for a behavioral interpretation of egalitarian preferences than previous attempts to derive them from interpersonal comparisons. Anyone who dislikes gambling to some degree and who doesn't know where he will land on the income pyramid would tend to prefer less inequality in the distribution of income. Moreover, I would expect civilized human beings to display some degree of risk aversion (although not an absolute aversion). I'm not convinced, however, that egalitarian social preferences must rest on personal risk aversion. Suppose a bunch of gamblers were forming a society from an original position; would they necessarily prefer a world in which the winner takes all or might they see some justice in a degree of equality?

cratic political process it establishes to select reasonable weights on specific issues as they arise.

Unlike Friedman, I would make the switch in the leaky-bucket experiment with enthusiasm if the leakage were 10 or 20 percent. Unlike Rawls, I would stop short of the 99 percent leak. Since I feel obliged to play the far-fetched games that I make up, I will report that I would stop at a leakage of 60 percent in this particular example.

If your answer, like mine, lay somewhere between 1 and 99 percent, presumably the exact figure reflected some judgment of how much the poor needed the extra income and how much the rich would be pinched by the extra taxes. If the proposed tax were to be imposed only on the handful of wealthiest American families with annual incomes above \$1 million, you might well support the equalization up to a much bigger leakage. In fact, some people would wish to take money away from the super-rich even if not one cent reached the poor. And those avid redistributors are not necessarily either mean or radical. Some think such a levy might help to curb the political and social power of the Hugheses and Gettys—an argument about which I expressed my skepticism in chapter 1. Others see it as a symbolic kind of environmental program; they feel that the villas, yachts, and jets of the super-rich poison our land, water, and air. Still others are frankly envious. For any of these reasons, many would go even farther than would John Rawls.

I shall now carry that leaky bucket on one final trip, in an effort to determine attitudes about various income levels. Consider two groups of families, one with after-tax incomes of \$10,000 and the other with \$18,000—figures that bracket the \$14,000 national mean in 1974. Suppose the proposal is to raise taxes on the \$18,000 group and aid the \$10,000 families by reducing the taxes they now pay. How much of a leak would you accept and still support that transfer? These families are quite far apart on the totem pole: the \$10,000

family is only about three-eighths of the way up, while the \$18,000 family stands four-fifths of the way to the top. I see some value in that redistribution, but my enthusiasm is limited; a leakage of 15 percent would stop me.

Somehow, everyone seems to develop a sense of where deprivation and hardship begin along the income scale. Among economists and laymen alike, the subjective threshold of deprivation most often mentioned is half of the average income of American families.⁷ If the average is taken as the mean, that would run about \$7,000 in 1974 (half the median would be \$6,000). Filling that gap seems far more important to many reformers than narrowing disparities above that level. That attitude has very important implications for policy. Additional doses of the old tax-and-transfer compound can essentially cure the deficiency below half of average income, as I shall argue below. But they would have only limited effects on the differentials between the \$10,000 and \$18,000 groups. To shrink those differentials significantly would call for alternative prescriptions. In particular, society would need to find ways for more people to climb the ladder from fair jobs to good jobs by choosing some combination of various proposals for expanded formal education, enhanced vocational and manpower training programs, subsidies to employers for promoting workers within their own ranks, or an induced narrowing of wage differentials between higher and lower job-classifications. These issues intrigue me. But because the bottom end of the income scale is the top of my priority list, I shall concentrate largely on the tax-transfer options.

7. The criterion of half of average income is used in Victor R. Fuchs, "Toward a Theory of Poverty," in Task Force on Economic Growth and Opportunity, *The Concept of Poverty* (Chamber of Commerce of the United States, 1965). Lee Rainwater finds that the public's subjective attitudes correspond to this criterion. See *What Money Buys: Inequality and the Social Meanings of Income* (Basic Books, 1974), pp. 41-63, 110-17.

Inspecting the Leakages

Just how leaky is the bucket? I can offer a few clues to the answer by inspecting the various inefficiencies of the tax-transfer reshuffle—administrative costs, reduced or (misplaced) work effort, distorted saving and investment behavior, and possible changes in socioeconomic attitudes.

ADMINISTRATIVE COSTS

The federal government has to hire people and buy computers in order to collect taxes and to distribute transfer payments. In addition, the taxpayer bears some costs of complying with the laws, including the time spent filling out forms and the fees paid to lawyers and accountants. These are deadweight burdens of the system and they absorb resources that could be serving productive ends. But the resulting leakages are fairly small and can be reasonably quantified; only a few percent of the contents leak out in this form.

WORK EFFORT

The impact of taxes and transfers on work effort is more difficult to assess. Suppose, as a result of increased income-tax rates, an individual takes more leisure and does less work than he would otherwise; then something leaks out of the real income and output available to all the citizens combined. In that case, to give poor Paul \$1, the extra tax will cut rich Richard's spendable income by more than \$1, by, say, inducing him to take an unpaid vacation that he would not otherwise want. The vacation must be worth something to Richard, but not as much as the income he would have chosen had it not been for the tax hike. Whether the net loss is viewed as a cut in the potential benefit to Paul or an extra burden on Richard, it is an inefficiency. In fact, dozens of

researchers have plowed into this area.⁸ They have uncovered virtually no significant effects of the present tax system on the amount of work effort of the affluent.⁹ Some limited effects of transfer payments have been found on the work effort of secondary earners (that is, ones other than the family head) in low-income families, but virtually none on primary earners.

It does not take a research project, however, to identify misplaced—socially unproductive—efforts devoted to tax minimization. High tax rates are followed by attempts of ingenious men to beat them as surely as snow is followed by little boys on sleds. One form of misplaced effort is on-the-job luxury financed by tax-deductible business expenses. That inefficiency is evident in some uses of company airplanes and yachts, business conferences in Capri and the Caribbean, and expense-account meals in posh restaurants that thrive on soft before-tax dollars.¹⁰ These cases seem more serious to me for their obscenity than their inefficiency. And they could be curbed significantly—although not entirely—by amendments to the Internal Revenue Code. Those amendments could tighten further the definition of an eligible deduction in the area of high living; or, instead of this stick, they could provide a carrot in the form of a stan-

8. See, for example, George F. Break, "Income Taxes and Incentives to Work: An Empirical Study," *American Economic Review*, Vol. 47 (September 1957), pp. 529-49; the literature is summarized by Break in "The Incidence and Economic Effects of Taxation," in *The Economics of Public Finance* (Brookings Institution, 1974), pp. 180-91.

9. The absence of dramatic effects should not be surprising. It could reflect a standoff between "substitution effects" and "income effects"—the two distinct and opposite influences implied by economic theory. Higher income taxes make leisure cheaper, setting off the substitution effect of trading work for leisure. But meanwhile they induce people to work more in order to avoid a major cut in living standards, as they reduce take-home pay and hence exert an income effect.

10. The one effort I know that seeks to document these practices is *President's Tax Message . . .*, Submitted by Secretary of the Treasury Douglas Dillon, at Hearings conducted by the House Committee on Ways and Means, 87 Cong. 1 sess. (1961), pp. 177-259.

dard deduction for firms that include no luxury-tainted outlays as business expenses.

At some high rate of income taxation, people might also shift their efforts toward more untaxed services of a do-it-yourself variety or switch into occupations that bestowed more untaxed rewards in the form of perquisites and amenities. But, so far as economists can see, that is not a great national trend.

SAVING AND INVESTMENT

The impact of high tax rates on the willingness to save and invest is the leakage cited most widely and confirmed least convincingly. If progressive taxation had had a massive and dominant effect on saving and investment, the evidence would be loud and clear in the aggregate data. In 1929, when all federal tax rates were low and barely progressive, the nation saved and invested 16 percent of GNP; in 1973, with all the allegedly onerous "soak the rich" taxes, it saved and invested the same 16 percent of GNP.¹¹ (And the evidence does not suggest that other forces, on balance, pushed up on the saving rate and hence might have offset some important downward pressures from the tax system.) Nonetheless, incessant warnings are sounded, as they have been for generations, that the next step toward greater progressivity will take saving and investment over a cliff. No doubt, the disincentive effects would become significant at some set of very high tax rates, but the terrain is a gentle slope rather than a cliff.

More fundamentally, the specter of depressed saving is not only empirically implausible but logically fake—as was

11. This reflects the operation of Denison's law, enunciated in Edward F. Denison, "A Note on Private Saving," *Review of Economics and Statistics*, Vol. 40 (August 1958), pp. 261-67. Paul A. David and John L. Scadding have recently confirmed its accuracy in "Private Savings: Ultrarationality, Aggregation, and Denison's Law," *Journal of Political Economy*, Vol. 82 (March/April 1974), Pt. 1, pp. 225-49.

the egalitarian argument of the thirties that redistribution was needed to cut saving and thus bolster consumption. Both are fakes because the nation can have the level of saving and investment it wants with more or less redistribution, so long as it is willing to twist some other dials. For example, any threat that greater progressivity would make saving inadequate could be offset by more federal saving through budget surpluses or more middle-class saving through special incentives. Similarly, investment demand could be bolstered by easing credit policies or strengthening investment tax incentives.¹²

Most fundamentally, the concern about the distortion of saving incentives through taxation implies that, with a properly "neutral" tax system, the marketplace would grind out an optimal level of saving and investment. But that is a fantasy. Collective decisionmaking—not the marketplace—controls the whole area of public capital formation for such diverse facilities as dams, post offices, highways, and hospitals. Moreover, investment in human capital is determined largely by public budgets for education.

The market rules investment decisions on private physical capital, but the conditions for optimality do not prevail. The market result can be optimal only if everyone faces the same interest rate, and hence can use the same scale to balance the productivity of extra investment against his time preferences for consuming more now rather than saving for later. As I emphasized in chapter 3, that neat balance is a grand illusion when some face 8 percent interest rates, others pay 36 percent, and still others cannot borrow at any price. So long as such disparities persist, there is no way to find the right national target for saving and investment in the marketplace. Decisions on how much the current generation should curb its consumption in order to bequeath more capital to

12. One egalitarian who faces up to these issues and opportunities is James E. Meade; see his *Efficiency, Equality and the Ownership of Property* (Harvard University Press, 1965), pp. 53, 59.

future generations belong on the agenda for collective choice as clearly as does national defense policy. The only hope for the proper participation of lower-income groups in such decisions lies in voting by ballots rather than by dollars. ✓

SOCIOECONOMIC LEAKAGES

Some of the concerns about leakages from tax-and-transfer redistribution focus on adverse effects on attitudes rather than losses of real GNP. They raise a different set of questions: Do high tax rates on the affluent jeopardize the motivating influence of the rags-to-riches dream? Do they imply an adverse ethical judgment on economic success that might make talented youths ashamed to strive for the jackpot prizes? With respect to the transfer recipients, do payments that are not linked to work harm pride in self-reliance or compromise the conviction that contributing is belonging?

At the same time, questions arise about potentially favorable attitudinal effects: Does equalizing help to broaden participation in the mainstream? Does it reduce the disruptive force of envy? Can a shared concern for the poor help to unite society?

The attitudinal impacts are associated with specific kinds of leakages; and, in light of them, some leaks may be particularly worrisome—even if they imply no major loss of real GNP. For example, a desire to hold open the route from rags to riches argues for some moderation in top-bracket rates on income and estates; a concern for self-reliance and the work ethic points to the development of transfer programs that promote wage-earning activity by the disadvantaged.¹³

13. My colleague Richard Nathan offered a particularly interesting personal reaction. Because he is most concerned about the dangers of a dependent class that has neither self-respect nor the respect of other citizens, he would support switches up to a much larger leakage in the leaky-bucket experiment if the leak involved mainly administrative costs and more leisure for the rich than if it were principally the result of diminished work effort by the poor.

FILLING THE BUCKET

Through leakages, the bucket loses part of its contents. But it can still hold plenty when it reaches the deprived if it is filled in reasonable ways.

Income Taxation

The progressive income tax is the center ring in the redistributive arena, as it has been for generations. In their ten-point radical program of the Communist Manifesto, Marx and Engels put it in second place—behind only the abolition of private land ownership.¹⁴ Yet, by 1913, that measure had become law through a constitutional amendment in this bastion of free enterprise. It was supported not only by ardent reformers but also by some middle-of-the-road groups, who saw it as a fair and reasonable way to divide the costs of public goods like the Army, the federal courts, and the regulatory commissions. Various concepts of ability to pay and of benefits of social protection were invoked to argue that a fair sharing of the tab for the federal budget required tax bills to rise more than in proportion to income.¹⁵

In the past generation, however, a revolution in the composition of the federal budget has rendered obsolete (or perhaps has unmasked as fallacies) these nonredistributive justifications for progressive taxation. Public goods provided by the U.S. government through purchases of goods and services have shrunk to 37 percent of the budget in fiscal year 1975, from 65 percent in fiscal year 1955. Meanwhile, trans-

14. Karl Marx and Friedrich Engels, "Manifesto of the Communist Party," in Lewis S. Feuer (ed.), *Basic Writings on Politics and Philosophy* (Karl Marx and Friedrich Engels) (Doubleday, 1959), p. 28.

15. For a comprehensive discussion, see Walter J. Blum and Harry Kalven, Jr., *The Uneasy Case for Progressive Taxation* (University of Chicago Press, 1953).