Equality and Efficiency: The Big Tradeoff

by Arthur M. Okun
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RIGHTS AND DOLLARS

American society proclaims the worth of every human being. All citizens are guaranteed equal justice and equal political rights. Everyone has a pledge of speedy response from the fire department and access to national monuments. As American citizens, we are all members of the same club.

Yet at the same time, our institutions say "find a job or go hungry," "succeed or suffer." They prod us to get ahead of our neighbors economically after telling us to stay in line socially. They award prizes that allow the big winners to feed their pets better than the losers can feed their children.

Such is the double standard of a capitalist democracy, professing and pursuing an egalitarian political and social system and simultaneously generating gaping disparities in economic well-being. This mixture of equality and inequality sometimes smacks of inconsistency and even insincerity. Yet I believe that, in many cases, the institutional arrangements represent uneasy compromises rather than fundamental inconsistencies. The contrasts among American families in living standards and in material wealth reflect a system of rewards and penalties that is intended to encourage effort and channel it into socially productive activity. To the extent that the system succeeds, it generates an efficient economy. But that pursuit of efficiency necessarily creates inequalities. And hence society faces a tradeoff between equality and efficiency. . . .

In this chapter, I will examine the ways in which American society promotes equality (and pays some costs in terms of efficiency) by establishing social and political rights that are distributed equally and universally and that are intended to be kept out of the marketplace. Those rights affect the functioning of the economy and, at the same time, their operation is affected by the market. They lie basically in the territory of the political scientist, which is rarely invaded by the economist. But at times the economist cannot afford to ignore them. The interrelationships between market institutions and inequality are clarified when set against the background of the entire social structure, including the areas where equality is given high priority.

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A society that is both democratic and capitalistic has a split-level institutional structure, and both levels need to be surveyed. When only the capitalistic level is inspected, issues concerning the distribution of material welfare are out of focus. In an economy that is based primarily on private enterprise, public efforts to promote equality represent a deliberate interference with the results generated by the marketplace, and they are rarely costless. When the question is posed as: "Should the government tamper with the market?" the self-evident answer is a resounding "No." Not surprisingly, this is a common approach among anti-egalitarian writers. Forget that the Declaration of Independence proclaims the equality of human beings, ignore the Bill of Rights, and one can write that only intellectuals—as distinguished sharply from people—care much about equality. With these blinders firmly in place, egalitarianism in economics can be investigated as though it were an idiosyncrasy, perhaps even a type of neurosis.

It is just as one-sided to view enormous wealth or huge incomes as symptoms of vicious or evil behavior by their owners, or as an oversight of an egalitarian society. The institutions of a market economy promote such inequality, and they are as much a part of our social framework as the civil and political institutions that pursue egalitarian goals. To some, "profits" and "rich" may be dirty words, but their views have not prevailed in the rules of the economic game.

To get a proper perspective, even an economist with no training in other social sciences had better tread—or at least tiptoe—into social and political territory. And that is where I shall begin. I shall travel through the places where society deliberately opts for equality, noting the ways these choices compromise efficiency and curb the role of the market, and examining the reasons why society may choose to distribute some of its entitlements equally. I shall focus particularly on some of the difficulties in establishing and implementing the principle that the equally distributed rights ought not to be bought and sold for money.

THE DOMAIN OF RIGHTS

A vast number of entitlements and privileges are distributed universally and equally and free of charge to all adult citizens of the United States. Our laws bestow upon us the right to obtain equal justice, to exercise freedom of speech and religion, to vote, to take a spouse and procreate, to be free in our persons in the sense of immunity from enslavement, to disassociate ourselves from American society by emigration, as well as various claims on public services such as police protection and public education. For convenience, I shall call all of these universal entitlements "rights," recognizing that this is a broader use of the term than most political theorists employ and that it lumps together freedom of speech and free access to visit the Capitol.

Rights have their negative side as well, in the form of certain duties that are imposed on all citizens. For example, everyone has a responsibility to obey the law—anyone who would merely balance the cost of risking a prison sentence against the benefits obtainable from stealing a wallet is violating that duty. Military conscription and jury service are examples of duties assigned—in principle, if not always in practice—by random selection and not according to the preferences or status of individuals. . . .

The Reasons for Rights

Why then does society establish these "inefficient" rights? The justifications for rights take three routes—libertarian, pluralistic, and humanistic.

Liberty

To the advocate of *laissez-faire*, many rights protect the individual citizen against the encroachment of the state, and thus convey benefits that far outweigh any cost of economic inefficiency. Freedom of speech and religion must be universal and unconditional; regulation, limitation, or discrimination with respect to them would vest discretionary authority in the government. Any condition for eligibility to vote that cannot be settled by the presentation of a birth certificate would give powers to some public official who might have an interest in keeping certain people out of the polling booth. Even if a literacy test administered by an objective deity would be desirable, one administered by a bureaucracy would be intolerable. The nice thing about universality and equality is that they are identifiable and objective criteria and hence hard to abuse. Thus, the libertarian embraces equality not because he cares at all for equality but because he cares a great deal about a limited government whose powers are circumscribed by explicit and objective rules. To him, rights are seen mainly as rights conferred on the individual against the state, and this view prevails explicitly regarding individual rights in the marketplace.

This explanation for equally distributed rights can take care of only part of the domain that is in fact defined by existing American institutions. It cannot explain why citizens entrust power to the state to prevent other individuals from encroaching on their freedoms. It cannot explain the whole sphere of civil liberties or public services. Nor can it explain government-imposed bans on the voluntary exchange of rights.

The traditional rationale for public interference with market exchange and for the public provision of services rests on so-called "externalities," which involve the interests of third parties. Environmental regulations are necessary because the pollution of the air and the water by one individual harms innocent bystanders. The production of services for national defense and lighthouses cannot be left to private enterprise because there is no effective way to keep the benefits channeled to the buyers and away from the non-buyers. No one can be permitted to bargain away his right to call the fire department in return for a tax cut, because his next-door neighbor would be made worse off. While that ban on exchange seems adequately explained by externalities, many of the other bans—for example, that on vote trading—do not. Even with the invocation of externalities, liberty cannot single-handedly explain the full range of rights in American society.

Pluralism

Another route into the domain of rights, stressing pluralism and diversification, can be sketched along lines developed by my teacher, Karl Polanyi. As he saw it, the network of relationships in a viable society had to rest on a broad base of human motives and human interests. Material gain is (at most) one of the many motives propelling economic activity. In turn, the economy is only one aspect of society and must be "embedded into" a successful society. Polanyi deplored a "market society" in which all other relationships would be subordinated to the marketplace. Rights can then be viewed as a protection against the market domination that would arise if everything could be bought and sold for money.

Everyone but an economist knows without asking why money shouldn't buy some things. But an economist has to ask that question. Every asset that lies in the scope of the market is measured by a single yardstick calibrated in dollars. All tradable goods and services are assigned their prices, and their values all become dimensionally comparable: a book is ten loaves of bread or two dozen bottles of beer. The imperialism of the market's valuation accounts for its contribution, and for its threat to other institutions. It can destroy every other value in sight. If votes were traded at the same price as toasters, they would be worth no more than toasters and would lose their social significance.

Society refuses to turn itself into a giant vending machine that delivers anything and everything in return for the proper number of coins. When members of my profession sometimes lose sight of this principle, they invite the nastiest definition of an economist: the person who knows the price of everything and the value of nothing. Society needs to keep the market in its place. The domain of rights is part of the checks and balances on the market designed to preserve values that are not denominated in dollars. For the same reasons that an investor holds many different stocks and bonds in his portfolio, society diversifies its mechanisms for distribution and allocation. It won't put all of its eggs in the market's basket.

One of these mechanisms is the rights bestowed on all the citizens. Another set consists of various nonmonetary distinctions that are awarded unequally in recognition of achievement but that are not allowed to bear price tags. Precisely because they cannot be bought for money, Olympic medals and Phi Beta Kappa keys have special value as motivating forces. Still another set of mechanisms consists of voluntary arrangements among individuals that are based on affection and fraternity. People want friendship and love for "themselves," and not for their money. The bond between friends is not merely bilateral philanthropy nor a mutual-assistance contract. These diversified mechanisms keep the market in its place and keep society from becoming a giant vending machine. They are the glue that holds society together.

Humanism

A third explanation for rights stresses their recognition of the human dignity of all citizens. John Rawls, the Harvard philosopher, has developed that rationale brilliantly, deriving a principle of "equality in the assignment of basic rights and duties" from a theory of the social contract. Rawls asks what kind of a social constitution would be adopted if all the framers of the rules operated in ignorance of their class position in the future society and of their relative standing with respect to assets and abilities. In such an "original position," in Rawls' term, the shared sense of justice as fairness could prevail with no distortion from self-interest, since all participants would be mutually disinterested. He concludes that these founding fathers and mothers would opt for equality in the "basic liberties" that relate to the freedom of the individual to follow his conscience, express his own moral principles, and participate in social decisions.

In Rawls' voluntary association, every member wants to ensure the recognition of the principles of self-respect and of fairness for all citizens, because that recognition protects him. The basic liberties are equally distributed because people value equality as a type of "mutual respect . . . owed to human beings as moral persons." These rights that are obtained without a quid pro quo recognize the worth of every citizen in the society. They go along with membership in the club. They then become the hallmarks of affiliation, a part of human dignity, and take on added significance for that reason. Because they are entitlements and not handouts, people can accept them freely without feeling like freeloaders.

The libertarian, pluralistic, and humanistic explanations of rights are not inconsistent; in modern American society, all three considerations play a role in the domain of rights. The preference for equality à la Rawls is one of the elements underlying the character and the scope of rights. The nature of the rights established by our institutions reveals that equality is one of our social values.

The Scope of Rights

How and where does society draw the boundary lines between the domain of rights and that of the marketplace? It is tempting to say that rights deal with noneconomic assets while the market handles economic assets. But that is circular. Since rights may not be bought and sold for dollars, and since they are distributed freely to citizens, they automatically lack the price-tag hallmark of economic "things." In that sense, rights define and delimit the range of economic assets. The Emancipation Proclamation took human beings off the list of commodities for which the market could set price tags. Less dramatically, if fire departments operated as public utilities and thus charged for their services, they would be viewed in economic terms. Because these services are provided as a right, they are pulled outside the framework of the market. But they nonetheless involve the use of labor and capital; they are paid for collectively through taxation; and their resource costs make them "economic."

To be sure, resource costs influence the boundary line. Any entitlement is more likely to be established as a right when it has relatively low resource costs, when economizing and comparative advantage and the other verities of the marketplace are relatively unimportant compared with the significance of broad sharing and common access. It is much less expensive, in every sense, to fulfill the right to free speech than a "right" to free food. But society does provide some costly or resource-using rights, like public education. And one way proponents of equality seek to narrow the differences in standards of living among Americans is to lengthen the list of resource-using rights. A government obligation to provide suitable housing or adequate diets for every citizen would, in effect, set a higher basic minimum of real income for all families. The advocacy of new rights can be carried to extremes. I once got into a heated debate with an audience of medical administrators when, taking what I viewed as an outlandish example, I suggested that any national health program should not grant me at public expense all the pairs of eyeglasses I might like. I learned to my surprise that they favored an unlimited right to eyeglasses.

Economists run into such surprises frequently. Nearly all members of my profession would favor some reliance on "effluent fees"—prices imposed on pollutants—rather than total commitment to complex, detailed regulations, as a means of allocating the safe and tolerable amount of discharge into air and water. But most legislators denounce such proposals as selling licenses to pollute to the rich. Suggestions that stiffer tolls might unclog our highways and bridges get a hostile reception. Arguments that interest rates should be flexible enough to clear financial markets that have ample competition are greeted with derision. Apparently, many public officials and their constituents want these items to be treated as rights and kept out of the marketplace. On a first reaction, I am baffled: When money buys bread and baby's shoes, why should it not buy these things? On second thought, a glimmer of understanding shines through. I think some of the critics are most concerned about extending the list of marketable assets, in general, rather than about including these particular items. They believe the scope of the marketplace is already too great, and they oppose any changes that would add new dimensions of economic inequality.

The Fuzzy Right to Survival

While I am not persuaded by the arguments for many proposed new rights, the case for a right to survival is compelling. The assurance of dignity for every member of the society requires a right to a decent existence—to some minimum standard of nutrition, health care, and other essentials of life. Starvation and dignity do not mix well. The principle that the market should not legislate life and death is a cliché. I do not know anyone today who would disagree, in principle, that every person, regardless of merit or ability to pay, should receive medical care and food in the face of serious illness or malnutrition. Attitudes about this issue have changed dramatically during the past century. At least some devotees of laissez-faire capitalism in the nineteenth century opposed in principle any right to survival, beyond the right to beg from private philanthropists. To them, economic efficiency required the forceful implementation of the rule that those who do not work shall not eat.

Although the right to survival now seems to be generally accepted, it has not been explicitly written into our statute books. It has been kept fuzzy, because its fulfillment could be very expensive. A formal and clear commitment that individuals could count on would increase the number who call for help. Uncertainty holds down the resource cost. To the needy, help is where they find it. Sometimes, it is found more easily from philanthropic organizations than from public emergency facilities. Sometimes, it is available only through some demeaning proof of dire need—thus imposing a toll of shame in lieu of cash, or a sacrifice of pride for a dinner.

Ever since the days of the New Deal, however, the federal government has increasingly assumed some of these obligations and formalized some commitments. In particular, the right to some minimum standard of consumption has been established for the elderly. The evolution of old-age retirement benefits into a right is instructive. The basic philosophy of social security has been and remains contributory, stressing the obligation of people to provide for themselves. Initially, those who had not been covered by the contributory system during their working careers were not entitled to benefits upon their retirement. For the first time, legislation enacted in 1966 bestowed some minimum benefits on all Americans over the age of 72, regardless of whether they had ever contributed to the system. Since then, the level of minimal entitlements has been increased and the age requirement reduced to 65 through additional programs that supplement the standard system of old-age benefits. Currently, the principle of contribution serves mainly to preserve pride while fulfilling the right to survival.

Issues surrounding the extension and implementation of a formal right to a decent existence are the heart of today's controversies about health insurance, the negative income tax, and welfare reform. Fulfilling that right is an urgent and feasible step toward economic equality in America, and I shall discuss that issue in detail. . . .

EQUALITY OF INCOME AND OPPORTUNITY

The Distribution of Economic Welfare

Income and wealth are the two box-score numbers in the record book on people's economic positions. Income is the more important of the two, because it provides the basic purchasing power for maintaining a standard of living; moreover, when property incomes are included, the income distribution reflects holdings of wealth.

Nonetheless, wealth is important in its own right and deserves some attention. In part, people accumulate wealth by saving the extra margin of income above their consumption expenditures. Over a wide range of income that spans the middle of the distribution, families save a roughly constant small fraction of their incomes. But at the very bottom of the income pyramid, people accumulate debts—to the extent they can borrow—rather than wealth. And at the very top, people save substantial fractions of their incomes, accumulating the bulk of the nation's private wealth. In addition to saving, receipts of gifts and bequests are an important source of large wealth. Much of the net worth of the wealthy reflects marketable assets, such as securities and real estate, which are passed on by inheritance from one generation to the next. In contrast, middle-class wealth typically takes the form of furniture, household equipment, and automobiles, which are worn out over the years rather than bequeathed to heirs. Middle-income families typically own their homes; indeed, roughly two-thirds of American families do. For most, that structure is the largest entry on their balance sheet, and the most important asset that is sold or bequeathed.

The differences in saving patterns and in bequest patterns of rich and poor make the distribution of wealth far more unequal than that of income. The richest 1 percent of American families have about one-third of the wealth, while they receive about 6 percent of after-tax income. The bottom half of all families hold only 5 percent of total wealth, although they receive roughly a quarter of all income.

Since dividends, interest, rent, and other property incomes come from wealth holdings, those types of income reflect the concentration of wealth and flow mainly to the top income groups. Including self-employment income from unincorporated businesses and farms and from professional practices, property income accounts for about one-fifth of total family income in the nation. One-tenth of all income comprises "transfer payments," items like social security and unemployment benefits for which no current services are provided in return. Transfers are the big equalizer, flowing principally to families whose earned incomes are low. By one statistical measure of income inequality, the degree of inequality of family incomes in 1970 would have been more than double its actual size in the absence of any government transfers.

The vast bulk—about two-thirds—of the income of American households comes from wages and salaries. Their distribution lies between the extreme lopsidedness of property incomes and the equalizing tendencies of transfers. Except among the lowest tenth of all families in the income distribution (where transfers are dominant) and among the top 3 or 4 percent (where property income prevails), wages and salaries account for at least half of the incomes of all groups.

For all families (excluding unrelated individuals), average income net of income taxes ("disposable" income, which is the concept I shall stress) was about $14,000 in 1974. Because some people receive ten and even a hundred times the average, the distribution is not symmetrical or bell-shaped like that of height or of scores on most ability tests. The family that stood exactly in the middle of the income pyramid—the median family that has half the population above it and half below—had an after-tax income of about $12,000. That median is less than the average because of the lopsidedness of the distribution. At the very bottom, 11 percent of the population are in families with incomes below the poverty line, which was drawn, sensibly but hardly scientifically, as the purchasing power required to buy a specified market basket of minimum adequacy. For a nonfarm family of four, that budget would have cost about $5,000 in 1974. The bottom fifth of all families had after-tax incomes under $7,000, and thus do not get much above the poverty line. The bottom third extended to about $9,500.

At the high end, the top fifth of families had incomes above $18,000. At a disposable income of about $28,000, a family got into the top 5 percent of the income pyramid. Most people at that level consider themselves middle-income rather than upper-income and are shocked to learn that their incomes exceed those of nineteen out of twenty American families. But it is only by comparison with their own friends, neighbors, and coworkers that they are just average. Or, in another sense, they do not have enough contact with average Americans to realize how unusual their economic status is.

The income distribution can be made to look soothingly equal or shockingly unequal, depending on how the figures are lined up. On the one hand, the portion of the income of the very affluent in excess of $50,000 per household amounts to only about 2 percent of total disposable income. That seems reassuring. On the other hand, the top 1 percent of families (those with roughly $50,000 and above) have as much after-tax income as nearly all the families in the bottom 20 percent. That seems terrible to me. And I find it disturbing that the top fifth of families have about as much after-tax income as the bottom three-fifths.

The relative distribution of family income has changed very little in the past generation. The nation took one big step toward equality during World War II; throughout the postwar period, the top income groups have received a substantially smaller share of total income than they had in the prosperous years of the twenties. Since the late forties, however, the proportion of income absorbed by each fifth of the population has inched only a tiny bit further toward equality. Roughly, at all points on the income scale, family disposable incomes in real terms (that is, corrected for inflation) have doubled in the last generation. As a result of the rising tide of progress, any average or absolute measure of real family income records dramatic improvement. The poverty-line living standard that was out of the reach of 11 percent of Americans in 1973 would have exceeded the incomes of about one-third a generation ago. But the percentage gaps between rich and poor have remained essentially constant, of course implying that the dollar differences between them have widened. And relative incomes have cultural and sociological importance. No self-respecting family in Boston can sleep in the streets, although that practice is quite acceptable in Bombay. Less dramatically, incomes that would have been regarded as reasonable and respectable a generation ago now leave a family outside the mainstream of middle-class life. The inability to own homes or cars or take vacations represents a greater deprivation to people who see most of their fellow citizens enjoying them.

Thus, while both the rich and the poor have experienced rising living standards, poverty remains the plight of a substantial group of Americans, and the large relative disparities in the income distribution continue to mar the social scene. . . .

Equality of Opportunity

Much of the interest in the sources of inequality reflects a conviction that economic inequalities that stem from inequality of opportunity are more intolerable (and, at the same time, more remediable) than those that emerge even when opportunities are equal. But the concept of equality of opportunity is far more elusive than that of equality of income and it defies any meaningful measurement. Basically it is rooted in the notion of a fair race, where people are even at the starting line. . . . But, as I noted . . ., it is hard to find the starting line. Differences in natural abilities are generally accepted as relevant characteristics that are being tested in the race rather than as unfair headstarts and handicaps. At the other extreme, success that depends on whom you know rather than what you know is a clear case of inequality of opportunity. And it seems particularly unfair when the real issue is whom your father knows.

The inheritance of natural abilities is on one side of the line of unequal opportunity, and the advantages of family position are clearly on the other. But much of the territory is unsettled. What aspects of the proverbial silver spoon should be regarded as creating inequality of opportunity? Does the line begin at differences in prenatal influences? Or at the benefits of better childhood health care, achievement-oriented training, educational attainment, family assistance in job placement, inheritance of physical property?

While the concept of equal opportunity has an indefinite boundary line, some areas of unequal opportunity are clearly evident. And some of these are amenable to remedial social action. The clearest cases are those outside the orbit of family relationships. Racial and sexual discrimination in jobs and pervasive preferential treatment in borrowing present obvious cases of inequality of economic opportunity. And they can be reduced by public policies that would enhance both equality of income and efficiency. In such cases, society can get more of two good things rather than sacrificing one for the other. . . .

The Potential of Equalized Opportunity

Nobody knows how much any combination of such measures could enhance equality of income or the efficiency of the economy. Guesses about their potential are in striking accord with general ideological positions; optimism hits a peak slightly left of center, and drops off in both directions. The right is convinced that opportunities are basically equal and that no heroic efforts at reform are needed. The left believes that no amount of equalization of education or hiring practices or the like will noticeably dent the amount of inequality. It views the system as rotten to the core rather than ragged at the edges. Of course, I want to believe that much of the inequality of income and wealth reflects inequalities of opportunity that can be efficiently corrected within the present institutional structure, just as conservatives want to believe that no corrections are necessary and radicals want to believe that no moderate corrections would be efficacious. All I would claim is that such efforts deserve a real try.

Opportunity and Results

I am confident that greater equality of opportunity would produce greater equality of income. To be sure, that is not a logical necessity, and one can imagine contrary examples. Suppose the silver spoons of privileged families work mainly to lift into the middle-income range those offspring who would otherwise wind up on the low end of the distribution (but do not benefit those who would make the middle or upper range on their own). Similarly, suppose the lead weights on the disadvantaged mainly hold down those who would otherwise rise to the top, keeping them close to the middle. Under those circumstances, inequality of opportunity would serve to reduce inequality of income. But those are unrealistic suppositions. Probably, in the real world, the silver spoons aid the able as well as the inept offspring of the well-to-do; similarly, the lead weights hold down all groups of children of the disadvantaged, making car washers out of potential middle-income policemen as well as policemen out of potential high-income doctors. Under those circumstances, inequality of opportunity must increase inequality of income.

Quite apart from its effect on the equality of income and on efficiency, equality of opportunity is a value in itself. Presumably it would be desirable to have fairer races. Interesting questions can be posed about how equality of opportunity should be traded off against equality of income when conflicts arise between the two. Such issues test the relative importance of the fairness of the race and the decent treatment of losers and winners. Both obviously matter. Unreasonable prizes and penalties are unacceptable, even if they are associated with fair races. The presumption that gladiatorial contests were fair made it no less barbaric to feed the losers to the lions. On the other hand, it does seem fair that losers in Olympic events go home disappointed and empty-handed. Such issues provide relaxing mental exercise, since equality of opportunity and equality of income are generally complementary rather than competitive objectives. That is one tradeoff that is not seriously vexing in the real world. . . .

INCREASING EQUALITY IN AN EFFICIENT ECONOMY

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, but it is important and 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. . . .

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. 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 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.

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. 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 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, 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.

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 democratic 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. 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. . . .

Conclusion

The fulfillment of the right to survival and the eradication of poverty are within the grasp of this affluent nation. And within our vision is the target of half of average income as the basic minimum for all who choose to participate in the community's economic life. The ability of industrial capitalism to end deprivation for all has been proclaimed for generations by conservative thinkers. Just before the Great Crash, Herbert Hoover stated his goal to "remove poverty still further from our borders." John Stuart Mill insisted that he would be a communist if he believed that economic misery and deprivation were inherent in a capitalistic economy.

And Mill was right; they are not inherent and they can be eliminated. Indeed, in a democratic capitalism, they must be eliminated. The society that stresses equality and mutual respect in the domain of rights must face up to the implications of these principles in the domain of dollars.

I have stressed particularly the urgency of assisting the bottom fifth on the income scale and helping them into the mainstream of our affluent society. I believe that programs to help them rise would generate momentum through time and into wider ranges of the income scale. If those at the bottom receive the contents of the leaky bucket and are granted greater equality of opportunity, most will get on their own two feet. As I noted in chapter 3, some other social scientists are less optimistic than I am, partly because they believe that only a small part of the existing inequality of income reflects family advantages or other inequalities of opportunity. That debate cannot be settled unless and until an effort is made to equalize opportunity.

In part, my optimism reflects my standards of successful equalization. I personally would not be greatly exercised about unequal prizes won in the marketplace if they merely determined who could buy beachfront condominiums, second cars, and college slots for children in the bottom quarter of academic talent. It is the economic deprivation that blocks access to first homes, first cars, and college slots for solid students that troubles me deeply. And through the kinds of reforms I have urged, these can become available to all who want them. As Tawney stated the goal, "Differences of remuneration between different individuals might remain; contrasts between the civilization of different classes would vanish."

Throughout this essay, I have sounded a recurrent two-part theme: the market needs a place, and the market needs to be kept in its place. It must be given enough scope to accomplish the many things it does well. It limits the power of the bureaucracy and helps to protect our freedoms against transgression by the state. So long as a reasonable degree of competition is ensured, it responds reliably to the signals transmitted by consumers and producers. It permits decentralized management and encourages experiment and innovation.

Most important, the prizes in the marketplace provide the incentives for work effort and productive contribution. In their absence, society would thrash about for alternative incentives—some unreliable, like altruism; some perilous, like collective loyalty; some intolerable, like coercion or oppression. Conceivably, the nation might instead stop caring about achievement itself and hence about incentives for effort; in that event, the living standards of the lowly would fall along with those of the mighty.

For such reasons, I cheered the market; but I could not give it more than two cheers. The tyranny of the dollar yardstick restrained my enthusiasm. Given the chance, it would sweep away all other values, and establish a vending-machine society. The rights and powers that money should not buy must be protected with detailed regulations and sanctions, and with countervailing aids to those with low incomes. Once those rights are protected and economic deprivation is ended, I believe that our society would be more willing to let the competitive market have its place. Legislators might even enact effluent fees and repeal usury laws if they saw progress toward greater economic equality.

A democratic capitalist society will keep searching for better ways of drawing the boundary lines between the domain of rights and the domain of dollars.

And it can make progress. To be sure, it will never solve the problem, for the conflict between equality and economic efficiency is inescapable. In that sense, capitalism and democracy are really a most improbable mixture. Maybe that is why they need each other—to put some rationality into equality and some humanity into efficiency.