Welfare economics: Promoting equality through general policies

openaccessgovernment.org/article/welfare-economics-promoting-equality-through-general-policies/162484

30 June 2023

Yew-Kwang Ng, Emeritus Professor at the Department of Economics, Monash University, continues a discussion about welfare economics, focusing on efficiency supremacy in specific areas, arguing that equality should be promoted through general policies

In the April issue, I published a piece on 'An Economic Analysis of Social Welfare' and, in an Open Access Government eBook, a piece on 'The Welfare Foundation of Public Policies and Its Implications'. Here, and in subsequent pieces in October 2023, January and April 2024, I will discuss some important messages of welfare economics for public policies.

Efficiency versus equality/distribution in welfare economics

Now, we will discuss the vital issue of efficiency versus equality/distribution. Efficiency is necessary but not everything. For example, if some people are wealthy, but many are very poor, efficiency alone may still involve a very undesirable outcome. Thus, public policies should pursue both efficiency and equality.

However, virtually in all cases, this simultaneous pursuit is not done efficiently. If this pursuit is done more efficiently, we could have more efficiency, equality, or both. Moreover, this may be achieved just by following a simple principle.

A simple principle to pursue efficiency and equality efficiently is to promote equality in the general (re)distributional policies of taxes and transfer and let efficiency rule supreme in specific measures. Contrary to this simple principle in welfare economics, most, if not all, pursuits in practice use many inefficient though equality-promoting policies in specific measures/areas, getting lower outcomes in both efficiency and equality.

To understand why this is so, first note that whether one is poor or not cannot be identified by one's consumption of a particular good.

Goods consumption and its relation to welfare economics

Madonna may consume little or no rice, while Yew-Kwang consumes a lot. That does not show that Yew-Kwang is richer than Madonna. Similarly, Yew-Kwang may consume no lipstick while Madonna consumes a lot; that does not indicate Madonna is richer than Yew-Kwang, though she likely is.

Instead, we must look at the total purchasing power or total income/consumption/wealth. [1] Thus, to increase equality in the whole society/economy, we should try to increase the total incomes of the lower income groups, not by subsidizing and taxing certain goods on equality grounds.

A common way to promote equality inefficiently is to suppress the prices of certain necessities like rice, housing, water, electricity, etc., by subsidies or price controls.

This is especially popular when the relevant prices have increased significantly due to higher demand and/or lower supply. For example, in 2023, rents for housing have risen substantially in Australia. As a result, the Green Party of Australia has advocated imposing a two-year rent freeze.

Since renters are taken as having lower incomes than landlords, such measures to depress rentals are believed to help the poor.

However, economists know rent control is ‘the most efficient way to destroy a city, other than bombing’. [2] The immediate effects of rent control may benefit the renters by having lower rentals than otherwise would be. However, the lower rentals reduce the rental accommodation supply, worsening the shortage.

Also, unable to increase the rentals, many landlords have no incentives to keep up with essential maintenance, significantly reducing the quality of rented units. Thus, the gains to renters (if any) of rent controls are typically much lower than the losses to the landlords, at least in money terms.

Nevertheless, if renters have much lower incomes than landlords, their gains, though less than the losses of landlords in money terms, may be higher in welfare terms.

This is so since the welfare significance of an additional thousand dollars is typically much higher if one is poor than when one is rich. Since welfare is of more fundamental value than money, should we not go by welfare comparison?

Yes, ultimately, we should go by welfare comparison. However, we may show that, following efficiency supremacy in specific measures (supplemented by appropriate general equality-promoting policies), we will achieve not just higher outcomes in money terms, but also in welfare terms.

The role of efficiency supremacy policy

On the issue of rent control here, following the efficiency supremacy policy means not imposing any rent control/freeze. As shown above (but in the opposite direction), this would make the landlords better off by more than the renters’ losses in money terms.

However, in welfare terms, the opposite may be true. Thus, efficiency supremacy in specific measures alone cannot ensure a higher overall social welfare level.

We must supplement the efficiency supremacy policy (such as not imposing rent control) with appropriate general equality-promoting policies. We can design these policies in a way that makes all income groups better off in welfare terms, achieving a Pareto- optimal improvement.

This is so because, in money terms, the renters' losses (from the absence of rent control) are less than the gains to the landlords. Thus, we only have to transfer (through the general tax/transfer system) less money from the groups of higher incomes (landlords) to the lower income groups (renters).

Nevertheless, the taxation of the higher income groups and the transfer to lower income groups will likely generate disincentive effects.

Taxing the higher income groups and transferring to the lower income groups

Economists, in particular, are emphatic about the importance of these disincentive effects. Thus, many of them also do not see the superiority of the efficiency supremacy policy (in specific areas and supplemented by appropriate general equality-promoting policies).

There are another more subtle points missed even by many economists (including myself before I wrote the 1984 paper), as explained below.

The supplementing equality-promoting policy of taxing the higher income groups and transferring to the lower income groups (denoted Policy A) is to offset the distributional effects of the efficiency supremacy policy like foregoing rent control as discussed here (denoted Policy B).

Thus, we have to look at the combination of both Policy A and Policy B. Policy A alone may have disincentive effects, but in combination with Policy B, the combined package can be designed to have zero disincentive effects.

This is so if, at each income level, the distributional effects of Policy A and Policy B are designed to offset each other exactly.

Then, the package has zero net effects in welfare terms at each income level, achieving zero disincentive effects. This is so as the amounts of disincentive effects depend on the combined outcomes of the whole package in welfare terms [(3)], not on its specific component only.

While all income groups are made indifferent in welfare terms, the package generates a surplus (as the additional taxes on the higher income groups are less than the additional transfers to the lower income groups) which may be used to make all groups better off, achieving a Pareto improvement, as proved more rigorously in my paper (Ng 1984) in the American Economic Review, a top journal in economics. [(4)]

Rent controls and incomes in consideration of careers and age

An additional point may be made on the specific issue of rent controls. Though renters may generally have lower incomes than landlords, the following considerations may offset this. First, many rentals are received by retirees who have invested in housing using their incomes while working.

On the other hand, many renters are young persons in the early stage of their careers. Though their incomes may be relatively low now, they will earn much higher incomes as they age and gain experience, and as the economy grows richer through technical progress.

Hence, taking an overall and long-run perspective, the presumption that landlords have much higher incomes than renters may have to be seriously qualified.

Some qualifications/considerations to our simple principle of efficiency supremacy may be added (discussed more in Section IV of Ng 1984). First, this principle requires some effective general equality-promoting policies to supplement the efficiency measures in specific areas.

Thus, for countries where such policies are absent or very ineffective, especially where the rich are cunning and powerful enough to avoid the higher taxes with impunity, our principle may have to be qualified, and the pursuit of equality using inefficient measures in specific measures may then be justified.

However, this qualification itself needs to be qualified. Suppose the rich are cunning and powerful enough to avoid higher taxes. In that case, they will likely avoid the effects of specific equality-promoting measures.

Considering environmental disruption

Secondly, while our simple principle precludes inefficient measures in specific areas, it does not rule out certain taxes/subsidies justified on efficiency grounds.

One important example is that if the consumption or production of certain goods involves important external effects like pollution and other environmental disruption, they should be taxed more. This is justified on efficiency, not on equality/distributional grounds.

In fact, it may be further noted that if certain taxes on pollution or other environmental disruption can be justified on efficiency grounds, they should be implemented for all consumers/producers irrespective of income levels. Instead of giving exemptions to such efficient taxes to lower income groups, it is better not to exempt them but to help them more through general equality-promoting policies.

Motivation for writing the 1984 paper

My initial motivation in writing the 1984 paper was provoked by a lunchtime conversation in 1974 with my mentor, Professor Ross Parish.

He told me that he was against the practice of some economists (including the eventual Nobel laureate James Mirrlees and his co-author Ian Little) in using income/distributional weights, making a dollar of the poor worth four times that of the rich, in cost-benefit analysis; to him, ‘a dollar is a dollar’. Due to the diminishing marginal utility/welfare of income, I argued that such weighting makes sense.

However, one may debate about the value of four times. Neither of us convinced the other during lunch.

Thus, I wrote a paper trying to show that a dollar to the poor should be worth around 16 times that of the rich. However, my right-wing brain beat my left-wing heart, and I concluded instead that ‘a dollar is a dollar (irrespective of income groups)’ or the efficiency supremacy principle discussed above.

This incident shows that the efficiency-supremacy conclusion of my 1984 paper was not due to right-wing ideology but logical analysis (though the validity of this may be open to debate).

In addition, I may also declare that, though my economic thinking is somewhat right of the centre compared to the general public, it is much left of the centre compared to economists. I can provide documentary proof of this declaration; the subtitle of my 2000 book is: With a Case for Higher Public Spending.

References

1. NG, Yew-Kwang (1984), Quasi-Pareto social improvements, American Economic Review, December, pp. 1033-49. https://www.jstor.org/stable/560
2. NG, Yew-Kwang (2000). Efficiency, Equality, and Public Policy: With a case for Higher Public Spending, London: Macmillan, 2000, pp. vii + 189. https://link.springer.com/book/10.1057/9780333992777
3. NG, Yew-Kwang (2022). Happiness: Concept, Measurement, and Promotion, Springer, open access at: https://link.springer.com/book/10.1007/978-981-33- 4972-8

Footnotes

1. For simplicity, we use the a-temporal framework ignoring savings, the stock and flow distinction, and other dynamic complications. Thus, consumption, income, and wealth are treated similarly.
2. I read this many decades ago in a first-year textbook on economics. However, my googling shows a source (Noah Smith of Bloomberg) that attributes this statement to Professor Assar Lindbeck (1930-2020), a Swedish economist who chaired the economics Nobel prize committee for many years.
3. For simplicity, we ignore some possible divergences between welfare (equivalent to happiness) and utility (representing preference). On these divergences, see Ng (2022, Ch.2).

4. Recognizing the practical difficulties of fulfilling the conditions at all income levels down to the difference of only one cent, the paper claims only a quasi-Pareto improvement, where all persons within an income group are better off as a group, but not necessarily every person individually.

Please Note: This is a Commercial Profile