The Efficiency-Equity Tradeoff

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> ***»** What is efficient might be inequitable. And what is equitable or fair, might be inefficient. Not true. In smart societies, equity and efficiency can rise together.*

A cliché of introductory economics courses is the trade-off between efficiency and equity. A market economy, it is said, is efficient: national income is maximized as profit-maximizing businesses and utility-maximizing consumers meet in the marketplace. The resulting market equilibrium may, however, be inequitable (unfair), with an excessive gap in income between the rich and poor. Taxing the rich to give money to the poor can then raise equity (fairness) but at the cost of distorting market incentives (such as incentives for hard work) and thereby lowering national income. The proverbial pie is shared more equally but the pie is smaller.

Dr. Arthur Okun, a wonderful US policy economist of the 1960s and 1970s (who was exceedingly kind to me when I was a fledging economist), used the metaphor of a leaky bucket. The bucket can carry money from the rich to the poor, but it leaks and loses money along the way. Should we favor taxing the rich $100 if only $50 reaches the poor? How about $20? How about $5?

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B.S. Frey, D. Iselin (eds.), *Economic Ideas You Should Forget*,
DOI 10.1007/978-3-319-47458-8_48

Alas, this fable is more alluring than truly insightful. The story highlights the importance of considering incentives when designing tax-and-transfer programs, but it misses the key reality of modern inequality. The most important component of income today is human capital, and the most important source of income inequality is the inequality of human capital, especially education and job market skills. The poor suffer not only from a deprivation of consumption but also of lifetime investments in human capital.

The key transfers aimed at reducing inequality are, therefore, not transfers of income per se, but transfers of human capital investments. Equitable societies ensure, through public spending, that every person, especially every child, receives the investments in health, nutrition, and education needed to build lifetime skills and health for productive employment and earnings. Such investments in human capital of children have some of the highest returns available to a society, yet the poorest households in society lack the cash income or borrowing capacity to make such investments out of their own finances.

There is, in short, no leaky bucket for the most important transfers that a society can and should make: universal provision of quality health care, childcare, pre-kindergarten schooling, and high-quality education from primary school through vocational or tertiary education. The ultimate educational attainment should depend on each child's aptitude rather than family income. In that case, \$100 taken from wealthy households can easily produce far more than \$100 in discounted lifetime earnings for poor households, by enabling these households to raise their children to their full physiological, cognitive, and scholastic potential.

Smart societies, like those in Scandinavia, are committed to this approach and recognize that equity and efficiency can thereby rise together; unwise societies, like my own country, the United States, fall very short of this ideal. All countries have recently committed themselves, at least on paper, to providing universal health care and quality education as part of the new Sustainable Development Goals (SDG 3 for health and SDG 4 for education) to be achieved by 2030.

Moreover, there is another important reason to doubt the leaky bucket story. It's hard to see how a society, sharply divided between rich and poor, could come close to even rudimentary efficiency, much less the high standard of raising every child to its potential. Unequal societies tend to be places of low social trust, unstable politics, and corruption. The rich may shield their incomes from the poor by manipulating politics (viz. America's addiction to unregulated campaign financing by the rich and powerful) at the cost of social unrest and a higher cost of doing business. Society then suffers in two ways: lower national income caused by crime, instability, and corruption and a decrement of psychological well-being of both the rich and poor due to a rise in social tensions, a deterioration of governance, and a decline in social trust and mutual support.