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Incentives and reflective equilibrium in distributive justice debates

Julian Lamont

Abstract: For the last thirty years one of the dominant economic policies has been the cutting of the top marginal tax rates. While this policy has been partly motivated by the self-interest of high income earners, it also has had considerable theoretical support from a wide range of distributive justice theorists starting with John Rawls' A Theory of Justice in 1971. Rawls argued that if the incentives created by inequality maximized the position of the least advantaged then they were morally justified. There have been many variants of this position since. The most common theme of them is that incentives to work harder and innovate, although creating inequality, are morally justified because of the greater good generated by the resultant increase in GDP. The main policy instrument available to governments to create such incentive has been the cutting of the top marginal income rates and this has been done systematically across all industrialized nations.

The method of wide reflective equilibrium requires us to use the best consensus from economics in our reasoning about distributive justice. The systematic cutting of tax rates over thirty years has provided a reasonable experiment on the thesis that such cutting provides an overall increased labor supply and resultant increase in GDP. The suggestion of this paper is that a reasonable consensus can now be reached that, over the ranges of inequality and GDP that we have had over the last 50 years and are likely to have over the next 50 years, such incentives do not provide the claimed benefits. Hence, we are getting increased inequality for no compensating benefit.

Keywords: distributive justice, incentives, inequality, income, tax, reflective equilibrium

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Introduction

There is much to be gained from having more interaction between economists, philosophers, political scientists and policy-makers on the topic of distributive justice and, ultimately, on economic policy. But given the innumerable overlapping interests, the question arises as to where best to focus the attention for the interaction. The suggestion pursued here is that settling a couple of fundamental issues on incentives is likely to be the most productive area given both the current state of distributive justice debates and the recent economic history of the industrialized world. With this in mind, the plan here is to try to harvest and present, two sets of findings which, if accepted, should be very helpful for better understanding the proper role of incentives in the context of distributive justice and economic policy. The advantage of doing this in an interdisciplinary journal is that theorists from different disciplines can cast different critical eyes over the material. Some economists will be best placed to determine whether the summaries of economic findings are in fact accurate and reliable for the purpose to which they are put. Philosophers and political scientists will be able to cast a philosophically critical eye over the claims to ascertain their plausibility and applicability to their own distributive justice views. Methodologists from all fields will be interested in the underlying discussion of reflective equilibrium and its application in this particular context. In this way we can start to establish a central set of relevant views to help focus the interdisciplinary dialogue on this important topic of distributive justice.

Incentives and GDP 1

Unfortunately, there is no single dominant characterization of "incentives". In the political context, the term "incentives" is used most commonly when talking about tax cuts. So, in the case of labor incentives, which are the main focus of this paper, the extra after-tax earnings that would occur as a result of cuts in marginal income tax rates are normally the incentives of interest. What most theorists have in mind, when talking about incentives, is a system of differential earnings. The idea is that the prospect of having differentially higher earnings gives people the incentive to work harder and/or more innovatively. Of course, these two usages are simply related – cutting marginal tax rates is one way to increase the differentials.

Over the last four decades there has been a dramatic reduction in the top marginal income tax rates across the industrialized world. A full specification of what has caused these cuts is outside the scope of this paper. Two obvious candidates are that such cuts have been politically advantageous to politicians; and the "conspiracy" view that various groupings of rich individuals who directly benefit from such reductions have used their political power to bring about the reductions. No doubt both of these causes are present to some degree. The third cause is the one of interest here because it is the one most amenable to rational argument.[1] Politicians and their advisers do not give as their reason for cutting the top marginal rates, "We're doing this because we think it is going to get us reelected" or "We're doing this because our political donors/cronies/supporters will be richer as a result." Instead, they give a reason, fairly consistent across all the industrialized economies, which is not so directly self-interested: that decreasing the top marginal tax rates will give people the incentive to work harder and/or more innovatively and thereby grow GDP. The variation in the reason usually occurs at this point in terms of the explanation for why growing GDP is good – more utility; more money for education/health care or other social services; more money to help the poor, and so on – the variations, though important, need not concern us here.

So the first empirical claim, of interest, is that having a system of differential earnings results in greater GDP than having a system of strict equality of earnings. The claim is clearly true, [2] so disputing it at this level of generality will not advance debates about distributive justice. The empirical issue of interest is what effect differential earnings, of the size that industrialized democracies have had over the last half century (and are likely to have over the next generation [3]), have on GDP.

An initial way of approaching this issue is to look at the literature examining the correlations between growth in GDP and the size of the earnings differentials. The available literature unfortunately mainly uses income differentials so it should be seen more as useful for shedding light on packages of incentives to work, invest and save, rather than just incentives to work. The predominant finding is that a negative correlation exists between income inequality and GDP. For instance, Alesina and Rodrik (1994), and Persson and Tabellini (1994), show that greater income inequality lowers subsequent growth after controlling for initial GDP per head and initial human capital (Pak). Moreover, it has been shown that this finding is robust under many different model specifications and to changes in the measure of income inequality (Clarke).

How useful are these findings for those concerned about distributive justice? Well, it suggests we should be wary of people/countries advocating/pursuing policies likely to increase inequality. Such people typically support their policies by claiming that increasing "incentives" will increase the economic pie and that squashing down the differentials dampens the incentives to work hard/innovate/save/invest etc. If this is correct, then we should expect those countries with higher income inequalities to have faster economic growth. However, the evidence suggests the opposite – slower economic growth. At best, the evidence suggests no relation at the relevant levels – increased inequality with no compensating increase in economic growth.

Reflective equilibrium and empirical data

To many economists it is immediately obvious that it is important to incorporate such economic findings into one's policy prescriptions. They are likely to disagree, though, about whether the findings above are accurate, i.e. whether the above is the right economic conclusion to draw from the literature and, hence, to use to shape policy. However, many philosophers and political theorists/scientists seem to have been much less convinced of the importance of economic findings to their deliberations about distributive justice (to the extent, in fact, that many are completely uninformed of the above findings and related ones). So it is worth defending, in some detail, the relevance of these findings to discussions about distributive justice and economic policy.

Consider, as an example, a normative theory having as one of its central claims that inequalities which increase the average income are morally justified. Neither political theorists nor the broader educated community evaluate this claim in an empirical vacuum. They evaluate such a claim within the context of their own perceptions of what their societies are currently like, have recently been like, and/or could possibly evolve into within their lifetimes. Now a philosopher arguing for such a moral claim is likely to have the empirical belief, shared by most economists around the world, that systems allowing some income inequality are likely to result in higher average income than systems that do not. The issue then becomes what concrete normative claims does this abstract moral claim yield for our current society? It is important to remind ourselves that we can only arrive at a claim about what should be done in the world by adding some empirical claims to the abstract normative claim. Although this is a simple philosophical point it is

one too often ignored in discussions about distributive justice. Moreover, for those many people who believe in the methodology of reflective equilibrium (Daniels), the conjoining of these empirical claims is essential for the assessment of the plausibility of their moral claims.

Suppose, for example, Betty considers a moral argument (along an analogous line, perhaps, as John Rawls' argument for his difference principle (Rawls)) and becomes convinced that inequalities are morally justified because they increase average income. Having developed this view, she may become engaged in intense debate with others, without ever surveying the economic literature to determine whether the empirical claim is correct – whether inequalities actually increase average income. Parties to this debate will all have their own beliefs, commonly not fully articulated, about what the relevant empirical facts are. Further, rather than just one relevant empirical fact, "inequalities do or do not increase average income," the empirical evidence may generate a range of facts with differing normative importance. It may be that inequalities far smaller than those currently existing have very significant positive effects on average income. It may be that small inequalities do not have significant positive effects on average income, but that the larger, currently existing inequalities do. It may be that only much larger inequalities will have significant positive effects on average income – and a range of positions in-between. People cannot rationally employ a method of reflective equilibrium without knowing the empirical literature, but most of the philosophical debates are not so empirically informed.

Evaluation of the claim that inequalities which increase average income are morally justified should require an examination of the current findings on the relationship between the various levels of inequality and average incomes. The original moral claim needs to be decomposed into a series of concrete moral claims about each combination of a level of inequality and the resulting average income. These concrete moral claims can then be tested against our considered moral judgments. Without doing this we cannot properly evaluate the original moral claim and assert we are committed to it. When doing this testing it is plausible to think that people will often come to have conflicts between their original abstract moral claim and their considered moral judgments about the world.

To take an extreme case, suppose Betty finds that the most plausible economic findings suggest that a relatively small increase in inequality away from perfect equality results in a very rapid rise in average income but that, after this rapid rise, only very small increases in average income result from much larger

increases in inequality. Then Betty may come to have less confidence in her original moral theory. For instance, she may think it omits consideration of another important value, say equality, which will sometimes conflict with the value of raising the average standard of living – this omission is, in a sense, revealed to her through her considered moral judgments about the concrete situations, even though she was not aware of it when constructing the original argument.[4] As is always the case with reflective equilibrium, she will have to choose between modifying her moral theory or her considered moral judgments or both. But even if she sticks to the original moral theory, without considering the empirical facts she should not be strongly committed to it because she has not properly tested it.

More generally, people should not be strongly committed to concrete normative claims which they think flow from their normative arguments without exploring the implementation of those in full cognizance of the relevant empirical facts. So, for instance, Betty should not be supportive of actual inequalities in her society unless she has investigated whether a lower level of inequality will increase the average income more.

In addition to this more formal point about rationality and reflective equilibrium, a point about rationally using one's intellectual energies should also be made. Suppose, for instance, it turns out that the economic evidence suggests that for the probable ranges of inequality politically feasible for our society over the next generation, the effects on average income are negligible. Then there is little point in having an impassioned debate about, or trying to further develop and refine moral arguments for, the abstract moral claim that inequalities which increase average income are morally justified – it will make no practical difference who is right.

Incentives and GDP 2

Having criticized the form of a group of philosophical debates about distributive justice and having emphasized the importance of the relevant empirical findings to those debates, it is important also to acknowledge how the empirical findings are often not conclusive or comprehensive enough to function in the way we would hope if we were rationally employing the methodology of reflective equilibrium. This is probably true of the findings relied on earlier – those concerned with distributive justice cannot get as much positive use from the current literature on

the relation between income inequality and GDP growth as they may hope. The main reason is that mechanisms by which income inequality and GDP growth are related are poorly understood.[5] So, for instance, we cannot assert that pursuing policies to reduce income inequality will increase GDP.

The empirical findings though are useful enough to justifiably make one very skeptical of anyone advocating policies which will increase inequality and justifying them on the grounds that the resulting incentive structure will increase GDP. That is a significant empirical point to add to the distributive justice literature. We may also be able to squeeze a little bit more out of the findings. The literature suggests that of the range of economies we have had over the last 50 years, the more egalitarian ones have a higher or equal rate of GDP growth compared to the more inegalitarian ones. If one believes that there are strong moral reasons for having a more egalitarian economy, and that inequality appears, at worse, not correlated with GDP growth over the range we are talking about, then one has reasons to start pursuing policies to increase equality and see where that leads. One of the most commonly cited impediments to pursue such equality – loss of GDP – does not seem significant, at least across the range of industrialized economies we have witnessed over the last 50 years. Indeed, you would continue to have such strong reasons to try out such policies, even if the dissident view, that the relationship is a weakly positive one, turns out to be correct. That seems very significant, but perhaps is mildly overstated given the nature of the economic literature on this topic. Time to start digging a little deeper into some related literature.

Income tax progressivity and labor supply

Before discussing tax/transfer systems in detail it is worthwhile making a quick relevant empirical observation/terminological stipulation about these systems. Most tax/transfer systems in existence could be replaced by equivalent tax systems and so it is simpler to just focus on the progressivity of the tax system. The fact that this replacement can be done is not without significance. The majority of countries provide little or no net transfers to the poor that could not replaced by lowering and averaging over time, the tax rate on the poor.[6] I think the majority of industrialized populations think that what is going on in their societies is that richer people are being taxed and the money is being transferred to the poor. However, what is not realized is that the transfers are not so large that an

equivalent distribution could not be achieved by instead reducing taxation of the poor. My guess is that there is more political support for reducing taxes on the poor than there is for transfers to them. If this is true, it provides a good reason for converting all current tax/transfer systems to tax only systems – but that is a topic for another time.

The discussion here will be confined to incentives to work because they have been the most commonly discussed incentives in distributive justice debates. Claims about incentives to invest and save are also important and some of the analysis given here can be extended to these but the extra complications they introduce would take us too far afield. To focus even more tightly, the rest of the paper will be focused on the issue of cutting marginal income tax rates.

One often hears references to efficiency-equity trade-offs as though these are a fixed feature of all economic policy decisions that take into account distributive justice considerations. Probably the most common of these supposed trade-offs is the one that is supposed to exist between tax progressivity and labor supply. The economic literature on this has been quite extensive – it has been responsive to the political interest in the issue. All the industrialized countries over the last 30 years have had a predominance of business leaders and politicians asserting that high marginal tax rates are a disincentive to work and that they should be cut. And indeed they have been cut, often dramatically. The important empirical question is what has been the effects of these tax cuts.

The most certain effect of the cuts is the significant role they have had in contributing to the increase in inequality in industrialized nations. For instance, for the UK, which has had one of the most dramatic rises in income inequality over the last twenty years (Gottschalk), Clark and Leicester find that the "tax and benefit reforms since 1979 look very regressive"[7] and that their results suggest that such "reforms" "may have contributed more than 40 per cent of the overall rise in income inequality" (156). Although there has been this significant rise in income inequality, the (usually implicit) claim has been that this is worth it because of the gains that come from the increased incentive to work. So we have two empirical issues of interest here:

(1) Progressive tax rates appear to be one of the main effective policy tools for dealing with inequality
(2) It is claimed that making income tax rates less progressive has a significant positive effect on the incentive to work.

The first claim seems settled. What about the second claim?

The first thing to note about the second claim is that there are heated ongoing disputes between economists about whether lowering top marginal tax rates increases labor supply (is positive) or decreases it (is negative). To an outsider it seems that people's research findings on this, not uncommonly, seem to follow their politics. This makes it difficult for anyone to work out what is the best consensus – what claims are outliers. Even given this difficulty it seems clear that whatever the truth is about whether the net effect is positive, negative or neutral, the *size* of the effect is not dramatic one way or the other. I think the following gives a reasonable summary of the state of play in the literature:

> An extensive literature in labor economics has shown that there is very little impact of changes in tax rates on labor supply for most people, particularly for prime-age working men (Pencavel; MaCurdy; Heckman; Moffitt).[8] This would seem to indicate that the central tenet of the Laffer curve is demonstrably false – marginal rates seem to have little impact on the amount that people work (Goolsbee 2).

Sometimes people, who are not familiar with the literature, disbelieve this finding. They think that it is obviously true that if people are able to earn more on their marginal income then they will work more. It is difficult to identify the source of this disbelief, whether it is because people have become convinced by constantly listening to public figures asserting the claim over the last 30 years. Or perhaps it is because they have in their minds a sketch of an economic model of human behavior which gives them confidence in their conclusion. This second source suggests it is worthwhile looking at the relevant economic model.

The model of what are the income and substitution effects of tax cuts on labor supply is a common one, readily found in most undergraduate labor economics text books. Despite this, it is worthwhile discussing it here because understanding it is likely to give people more confidence in the empirical results – they will have a plausible model of human behavior to explain the empirical results.

For those who want an intuitive explanation rather than the formal model of the textbooks, it can be understood along the following lines. Cutting the marginal rate of income tax effectively raises the after-tax wage rate for an individual. The overall effect this has on the individual's choice of how many hours to work can be thought of as being made up of two separate effects which work in opposite directions. The first effect, the substitution effect, is the one that obviously most people conjure to mind. The increase in the wage rate effectively makes leisure

relatively more expensive than it was before the increase in wage rate. An hour of work foregone now involves a greater loss than it did before. This motivates people to work longer – the payoff is now greater for the extra work.

The income effect works in the opposite direction. Cutting the tax rates effectively makes people wealthier than they were before – for the same amount of work they receive a higher, after-tax income. If people think of leisure as a normal good, which they do, then when they receive higher incomes they will "purchase" more of this good. They will buy more leisure and hence work less. This is a phenomenon with which we are all familiar. It manifests itself in innumerable ways. From the doctor who decides to play golf every Wednesday afternoon; to the parent who decides to work less hours and spend more time with the kids because they have enough to cover the mortgage and what they consider are the necessities of life; to the "seachange" or "downsize" phenomena; through to the innumerable people who retire early and hence "purchase" a lot more lifetime leisure.

The total change in hours worked then is the sum of these two effects. Cutting marginal tax rates gives people the incentive to work more because they can earn more per hour from working than they did before (the substitution effect). At the same time it gives them an incentive to work less because they are wealthier as a result of the tax cuts and so can afford to take more leisure time and still satisfy their same consumptive desires (the income effect). The theory does not postulate any necessary relationship between the sizes of these two effects. They work in opposite directions and you need to go look at the world to see the relative size of these effects. They will be different for different people. If, over the whole economy the substitution effect is smaller than the income effect, then the overall effect of an after-tax wage rise is a net reduction in hours worked. If the substitution effect is larger than the income effect, then there will be a net increase in hours worked. The central empirical finding, crucial for all debates about distributive justice and economic policy, is that the effects are similar in size.

The earlier retirement phenomenon is worth commenting further on in relation to the empirical findings. There are two main mechanisms by which the income effect can operate. The first is by people reducing their hours of work. The second is by people not reducing their hours of work but continuing to work the same and then retiring earlier (the leisure is "bought" in a lump sum at the end). The existence of these two mechanisms introduces considerable difficulty into getting reliable data except over very substantial periods of time. It is further complicated by whether people think the tax cuts are permanent or temporary.

In the 1980s there were very substantial cuts in marginal income tax rates in most industrialized countries. This would have provided a very good experiment for testing the size of the income and substitution effects. From that point on we could observe people's behavioral response in terms of total lifetime hours worked. Note that it is total *lifetime* hours worked that is important. So, for instance, it would be compatible with the income effect being larger than the substitution effect that people during the 1980s and 1990s substantially increased their working hours over what they were working in the 1970s and then retired or intend to retire earlier than they would have in the 2000s and 2010s – as long as the increase in hours worked was more than offset by the hours lost by early retirement. In a sense then the experiment of any of these tax changes is not over until the people who experienced them have retired. A further complication comes about if people do not think the tax reductions are permanent. The large tax cuts of the 1980s were indeed not permanent particularly in the US. Many countries wound back the large cuts back during the 1990s, though not fully.[9] For all those people who suspected the supply-side economic theory was wrong, and that would have included a lot of people who knew nothing about economics but pretty quickly observed spiraling deficits, it would have been rational to considerably up their work efforts while the taxes stayed low – the old "make hay while the sun shines" phenomenon. If this was the case, then we might expect an even greater increase in working hours to be observed during the 1980s and this would still be compatible with the income effects being greater than the substitution effects – it all depends on how the retirement patterns play out. Unfortunately (only from the epistemological point of view), the experiment was changed in the 1990s with the winding back of some of the cuts, so we do not have the nice data that we could have had. Still, the data we do have so far suggests the effects are of a similar size. But, as noted, the experiment is still ongoing. If the baby-boomers retire earlier than they would have, that will further push the results towards marginal income tax cuts having no or negative effects on labor supply.

Conclusion

The central claims here are as follows:

1. The large cuts in marginal income tax rates occurring over the last 30 years have not provided the extra incentive to work. The tax cuts did not cause a significant net increase in labor supply and hence did not cause an increase in GDP. Hence, there was no resultant good that resulted from the cuts in marginal income tax rates.

2. The cuts in the marginal income tax rates did significantly contribute to an increase in income inequality over the last 30 years.
3. Hence, one of the most significant economic policies of the last 30 years is a failure.

If this is right then it should now play a central role in discussions of distributive justice and economic policy over the next generation. The belief that there was a need for labor incentives, in terms of greater post-tax income differentials and lower marginal tax rates than existed in the 1960-1970s, in order for economic growth to occur, was a false one. This is a crucial result for those distributive justice theorists and others who believed that incentives provided by larger income differentials (and brought about by the main mechanism available to governments to achieve this – reduction in top marginal tax rates) are morally justified by the resultant growth in GDP (and whatever good they believed was associated with this). Indeed it is a crucial result for all those agonizing over the supposed equity-efficiency trade-off in this area. The result is that for the range of differentials we have had in the last 60 years and are likely to be able to achieve in the next 50 years, there is no noticeable trade-off. If equality is a good then, we have no reason not to pursue considerably more of it than we currently have in 2008.

John Rawls said, when discussing the wide reflective equilibrium required for distributive justice belief formation, that we need to take the best consensus from the social sciences on their particular epistemological domains in reasoning about distributive justice and hence economic policy. The question at this point is whether there is such a consensus on the three points above?

Endnotes

[1] It also feeds into the first cause. Presumably cutting top marginal tax rates has been politically popular because significant numbers of people have some combination of empirical and normative beliefs which make them believe such cutting is good.

[2] In saying it is clearly true does not commit one to any sweeping claim that humans are only motivated by money – clearly, an empirically false claim. All it commits one to is that the prospect of earning more income is one, among many, of the motivating factors for people.

[3] The qualification "over the next generation" is inserted at various places because it is a worthwhile discipline on the discussions which is too often ignored, particularly by philosophers. It seems rational, in the area of distributive justice, to use one's intellectual resources to focus on time frames for which you have at least reasonable information. A time frame of a generation is not overly conservative while at the same time takes account of the practical/epistemological constraints that face us.

[4] The earlier claim that it is irrational to omit the discovery of relevant empirical data is perhaps too strong. One could achieve a similar result by conjoining each *possible* empirical result and testing one's judgment against the outcome. Of course, theoretically there are an infinite number of possible empirical results, but even if we reduced them down to series of sets it is still horribly inefficient to proceed this way rather than looking at the real empirical results for the same purpose.

[5] For an examination of one of the possible mechanisms, along with references to papers exploring other mechanisms, and to papers which find no or a positive relationship between income inequality and GDP growth, and to some criticisms of these papers, see Sylwester.

[6] The scope of this claim is widened and strengthened if unemployment benefits are considered, not as transfers to the poor, but as social insurance payments to the unemployed. To put it another way, what some consider as transfers to the poor because they are poor are more properly considered as social insurance benefits paid to the unemployed and justified by reference to their involuntary unemployment with the insurance premiums paid by them while they are working. The claim is also strengthened if we consider transfers over lifetimes rather than over some lesser period such as a year (Harding).

[7] While Clark and Leicester's "results seem robust to the chosen year of data on which reforms are imposed and also to the choice of inequality measure. We have estimated confidence intervals which are narrow, suggesting that our results are unlikely to reflect sampling error" (Clarke 156), their results are very sensitive to the choice of counterfactual world used for comparison.

[8] The statement is less true for women deciding whether to enter the labor force (Eissa) and possibly for certain groups of workers such as doctors (Showalter) or entrepreneurs (Carroll) (Goolsbee).

[9] Of course, this was partly due to the spectacular failure of the supply-side economic theory (sometimes called Reagonomics) – the idea that the tax cuts would induce such an increase in the incentive to work and innovate that overall tax revenues would not be affected by the tax cuts. Once, the deficits started climbing dramatically it became pretty clear to everyone that the theory was wrong.

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