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## How Bright are the Northern Lights? Some Questions about Sweden

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### Chapter 3

## Explicit, Implicit, and Efficient Redistribution

Most people use the phrase "income redistribution" to refer to transfers to relatively low-income people through social insurance or welfare-state programs explicitly designed to reduce the inequality of the distribution of income. But many other kinds of governmental intervention also change the distribution of income, as does collective action of groups of firms or workers in the marketplace. The tariffs, import quotas, and other protectionist measures considered in the last chapter undoubtedly change the distribution of income - they change the prices of some products and thus also the returns to the firms and the owners of the labor and other resources that produce these products. Public subsidies, price supports, and tax loopholes obviously also change the distribution of income. Even many public policies that have little or no significance in the budget of the government - such as regulations that restrict entry, limit competition, fix prices, or mandate benefits to employees and others - change the distribution of income. Similarly, whenever firms or workers successfully combine, whether through explicit cartelization or tacit collusion, to change prices or wages this again changes the distribution of income.

### ***"Implicit" and "Explicit" Redistributions***

It is useful to label the money and the services that governments openly transfer or provide to low-income people, simply because they are deemed morally to deserve or need the assistance, as *explicit* redistributions. By contrast, when a society is persuaded to choose a policy mainly for some reason *other* than its redistributive effect - as is the case when a society protects manufacturers against competing imports, or regulates prices or competition in some industry, because it is persuaded that will further the

development or strength of the country - that redistribution will here be called an *implicit* redistribution of income.

In keeping with standard usage in economics, I define the social cost of a redistribution, whether it is explicit or implicit, as only the "deadweight loss" or "excess burden," that is, the reduction in the national income from the transfer. If one group is taxed to finance transfers to another, the social cost is the reduction in the income of the society that results from any impairment of the incentives to work, to save, to innovate, and to allocate resources to their most productive uses, plus the costs incurred in administering the transfer. The amount that the taxpayers transfer, though obviously a matter of interest to them, is not a loss or cost to the society since the recipients of the transfer are also a part of the society. This definition of social cost is standard in economics and is obviously also the one that is relevant when explaining the rate of economic growth or the level of per capita income in a society.<sup>1</sup>

Of the many of redistributive activities, both explicit and implicit, that take place, which have the greatest social cost for each dollar or crown redistributed? Strangely, this subject, important as it is, has been so badly neglected that we must work out much of the analysis from the start.

### ***The Criteria for Redistributions Generate the Social Costs***

In economic theory, there is a familiar answer to the question of what type of redistributions has the least social cost: the "lump-sum" transfer, by definition, has no impact on incentives and thus no social loss whatever associated with it. The concept of the lump-sum transfer is a useful simplifying device in theoretical discussions, but all sides agree that no society could in practice have a continuing program of lump-sum transfers. The continuing transfers would be taken into account in behavior and thus would affect the incentives and the income of the society. So the practical question is, what types of systematic transfers that are actually possible will come closest to the lump-sum ideal?

Although there will inevitably be some excess burden from the taxes that raise the money for a transfer, the deadweight loss can usually be minimized by an *unconditional cash* transfer. If the recipients of the transfer are not required to do or not do anything to receive the transfer, the transfer will not have any effect on the incentives that they face.

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<sup>1</sup> If any expenditure, whether by the private or the public sector, actually increases the national income, then I will classify it here as an investment rather than a redistribution, even if the increase in income does not spread evenly throughout the society. Thus a public investment in the skills of the poor (or, for that matter, a program for the rich) that did in fact increase the national income would not be considered a redistribution, no matter how much this shifted the distribution in favor of the poor (or in favor of the rich). Our problem will become intractable unless we distinguish redistributive activities from investments and changes in the supplies of productive factors.

If the transfer is in the form of cash, the recipient can use it as he or she pleases, so there is also no distortion of the consumption choices of recipients.

The great practical force of this point is evident if we consider an uneconomic industry. Assume that, say, the shipbuilding industry has lost its comparative advantage, so that the costs of operating the shipyards are greater than the revenues that can be obtained and that in the absence of any redistribution to the industry they would be closed down. Let us stipulate that there is no external economy to justify any subsidy on grounds of social efficiency and that any aid or protection for the industry arises only because of the political pressure applied by the shipbuilding companies and workers to obtain protection or aid for themselves.

Suppose the organized shipbuilding companies and the workers through lobbying obtain a ban on the purchase of foreign ships. Protectionism benefits the firms and workers who sought it *only as long as they remain in the industry*. If the criteria for getting any kind of government aid is (as it usually is) that the firms and the workers continue to remain employed in the industry, then the recipients will have to allocate their time and other resources to shipbuilding to qualify for the redistribution.

Keeping the losing industry going entails that the resources devoted to it produce output of less value to the society than they would have produced in the most attractive employment in unsubsidized sectors of the society. That is, these resources are partly wasted and there will therefore be a cost to the society beyond that of the taxes or other direct costs of the redistribution.

This argument applies not only to bailouts and aid to declining industries, but also to redistributions to growing industries. If there is, say, a redistributive tariff or subsidy that raises the price in a thriving industry or activity, then *other* resources will move to take advantage of the higher price and these entering resources will then usually produce less value to society than before. This migration will cease only when the marginal *private* return is the same in the favored activity as elsewhere, but then the return to society at the margin will be less than the return to identical resources in unsubsidized areas. The migration to subsidized areas also means that some of the redistribution will, from the point of view of those who sought it, be wasted.

Usually, redistributions of the typical kinds to any industry, occupation, or region, or any redistribution to the users of some input, will mean resources are allocated in a way that produces less value to society. That is, subsidies or regulations that favor a particular group rather than correct a market failure - and are accordingly simply redistributive<sup>2</sup> - generate losses for the society. They generate social waste because

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<sup>2</sup> Though they won't matter much for the argument here, there are some complexities that need to be dealt with to isolate the smaller implicit redistributions. To determine whether a measure is "simply redistributive," it is necessary to specify an initial or reference set of institutions and policies in order to delineate changes. Any stipulated set of initial conditions may, of course, be controversial; there are different ideas about what institutions are most productive. Thus some observers might object to any given measure of the extent of implicit redistribution because they objected to the initial state in terms of which the change in policy was defined. (The note continues on next page.)

normally the criterion for receiving the redistribution to an industry or occupation or locality is that the relevant firms or workers must allocate their capital and their time to the favored sector rather than to the sector that would, in the absence of the redistribution, have been most profitable.

To keep the costs of the redistribution from becoming insupportably high and to prevent the redistribution from being "wasted" on those for whom it was not intended, regulations or limitations are often established. A government regulatory agency may be created to prevent "abusive" or "speculative" actions to take advantage of the subsidy and to prevent an oversupply of the subsidized good. Sometimes only the original firms and workers will be legally entitled to receive the higher price or other subsidy in question. In declining industries the regulatory measures may even be designed to induce some of the excess resources to leave the industry at the same time that the protection or subsidization make the industry more profitable than it would otherwise have been. Such measures can reduce the extent to which conditional redistributions distort the allocation of resources a cross industries.

### ***Slower Innovation as a Deadweight Loss***

Restrictions and regulations also have to be applied in practice and enforced, and this entails some administrative or regulatory involvement in the productive process. The costs of the bureaucracy needed for this purpose may not be very large, but the social costs of the extra complexity, rigidity, and delay are rarely small. If the benefits of a higher price or any other subsidy are to be restricted to the original capital and labor in the relevant industry, then some authority must decide what whether a given expenditure is just maintenance and repair or really a new investment. If the regulation is going to block the extra output that would otherwise result from a higher price or other subsidy, then the level of output of each firm must be monitored and controlled.

If new investment or output are controlled, the incentive to innovate is no longer so clear. If exploiting a new technology or idea changes the optimal level of investment and production, as it usually does, the new desired new pattern of investment or production is unlikely to get the needed regulatory approvals without delay. Those enterprises that would lose from a rival's innovation can also use the politics of the

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Note, however, that the concept of implicit redistribution is applicable whatever initial distribution of endowments or wealth is preferred - the desired distribution of wealth can be obtained by *explicit* redistributions. To delineate implicit redistributions we need only distinguish productive measures that increase social income from those that implicitly redistribute it. Of course, even this can sometimes be very difficult.

Since this book is concerned only with implicit redistributions that bring *large* deadweight losses, this complication is not a major difficulty here. There is not much controversy among skilled specialists about which policies that have large excess burdens.

regulatory process to block the innovation.

Thus the controls that are needed to prevent waste and abuse in a subsidized sector normally delay innovation and slow the reallocation of resources. The social cost of conditional redistribution often includes a lower rate of innovation and a less flexible economy. Some economists speak of "excess burdens" and "deadweight losses" only in static contexts where innovation, flexibility, and productivity growth are irrelevant, but this usage is misleading and (since the dynamic losses are usually much larger than the static costs) also mischievous. In this book, the excess burden or deadweight loss resulting from a conditional redistribution includes the slower productivity growth that regulation and other complex decision-making procedures bring about.

If those in the protected, subsidized, or cartelized industry are simply given cash from the government with no strings attached, then the total cost to the rest of society is merely the sum transferred plus the deadweight loss of the taxes that obtain this sum; the recipients of the cash still have an incentive to allocate their capital and their labor to whatever employments offer the highest returns, and (in the absence of other market failures) these will be in the sectors with the highest marginal return to society. It is true that the beneficiaries of the unconditional cash subsidy will be better off because of the transfer to them, and the "income effect" of the transfer could make them take more leisure, but this does not reduce the *efficiency* of the society. Some have more income and may take more leisure, and others have less income and take less leisure, but (apart from the *excess* burden of the taxes) the efficiency of the society is not changed.

The new distribution of disposable income arising because of the redistribution may or may not be unjust, but that is a separate issue that is not relevant to the present question of which types of redistribution have the lower social costs. When a redistribution is by its nature or conditions restricted to those who remain in the existing pattern of activity, it is usually possible to provide the recipients with the same net gain, at a smaller cost, by giving them an unconditional cash payment. Thus no amount of moral concern about fairness alters the reality that it is the criteria or conditions inherent in protectionism and in most aid to industries, occupations, and localities that increase their social costs.

It is also important not to overstate the point that has just been made. It is possible that the excess burden of the taxes needed to finance an unconditional cash transfer could exceed the deadweight loss from the protection, monopoly, regulation, or other devices are often used for an implicit redistribution.<sup>3</sup> In this case the unconditional cash transfer would not be the cheapest form of redistribution. Essentially, the reason for this is that tax burdens are also conditional - the amount of tax we have to pay is understandably conditional on how much income we earn and thus on how much we work and save, and this makes our individual choices socially less efficient. The conditionality inherent in taxation could cause greater distortions than the conditions on the typical implicit redistribution. The logical possibility that a typical measure for

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<sup>3</sup> I am grateful to Stephen Baba for reminding me of this.

implicit redistribution could have a lower social cost than a typical implicit redistribution is not, however, so important in practice. This study will go on to indicate reasons why the social costs of many implicit and conditional redistributions will, in reality, usually become far higher than an unconditional cash transfer would have been.

### ***Conditions on Explicit Redistributions to the Poor***

The idea of conditionality as the source of distortions can also be applied to explicit redistributions to low-income people. There is one criterion for most such transfers that causes them to have a greater deadweight loss than an unconditional cash transfer of equal size. One nearly universal condition on welfare-state grants for the poor is that they will no longer be available if the recipient becomes prosperous. This condition is only natural and proper, but we must, if we are being honest, recognize that it entails some deadweight loss: the poor person who somehow mitigates his or her plight thereby loses some transfers, and this reduces the poor person's incentive to obtain an income high enough to end the redistribution.

As this last illustration suggests, the point of my argument is not to advocate redistributions with no strings attached - it is rather to make clear that the criteria or conditions that qualify an individual or firm to receive redistributions are the main source of their social costs. This idea, and the distinction between explicit and implicit redistributions, are indispensable for a full understanding of economic efficiency and growth in the modern world.

### ***The Theory of Efficient Redistribution***

We can also now begin to assess what I like to call the theory of "efficient redistribution," which grows out of the work of Gary Becker, Donald Wittman, Earl Thompson and Roger Faith, and others.<sup>4</sup> Although different advocates of this theory make somewhat different arguments, the most basic idea, at least in Gary Becker's formulation, is that those who lose from redistributions of income have an incentive to

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<sup>4</sup> Gary Becker, "A Theory of Competition Among Pressure Groups for Political Influence," *Quarterly Journal of Economics*, (August 1983), pp. 371-400, "Public Policies, Pressure Groups, and Dead Weight Costs," *Journal of Public Economics*, 28 (1985), pp. 329-347; Earl Thompson and Roger Faith, "A Pure Theory of Strategic Behavior and Social Institutions," *American Economic Review*, vol. 71 (June 1981) pp. 366-80; Donald Wittman, "Why Democracies Produce Efficient Results," *Journal of Political Economy* Vol. 97, No.6, (December 1989), pp. 1395-1424; and Bruce Gardner, "Efficient Redistribution Through Commodity Markets," *American Journal of Agricultural Economics*, vol. 65 (May 1983), pp. 225-34.

keep their losses to a minimum. When a redistribution to one group in a society increases to the point where the losses to others become large, then the resistance to this redistribution also increases. If the losses are substantial, Becker emphasizes, there will be so much political resistance that the redistribution is almost certain to be curtailed.

The deadweight losses from redistributions obviously add to the losses of those who lose from the redistribution, and they do not, of course, help the beneficiaries of the redistribution either. Both the gainers and the losers therefore have an incentive to keep the excess burden to a minimum. Indeed, they have an incentive to bargain with one another until they maximize the joint gains that they can obtain from reducing excess burdens - in other words, an incentive to continue bargaining until the society has achieved an efficient allocation of resources.

In Donald Wittman's formulation, at least, it is only the time and other valuable resources used up in the bargaining - only the transactions costs - that keep a society from achieving the most efficient state we can conceive of. But transactions and bargaining costs are an inescapable feature of reality, and the cost of the time and other resources that they use up is just as meaningful as any other cost. So transactions costs, like the costs of any productive activity, should be part of the costs we take into account in defining a Pareto-efficient or totally efficient state. Some of those who use the theory of efficient redistribution therefore conclude that the existing societies, notwithstanding the redistributions they often engage in, are essentially Pareto-efficient.

Accordingly, the theory of efficient redistribution predicts that any social losses from redistributions are small and that redistribution is, at least for the most part, "efficient redistribution." Unstinting proponents of this type of thinking, such as Thompson and Faith and Donald Wittman, therefore say (in effect) that our world could not be much more efficient - that this is, indeed, the best of all possible worlds.

If the theory of efficient redistribution is right, then we seem to have an answer to our second question: any redistribution that actually occurs anywhere is quite efficient and so any social costs are small. It follows that Sweden cannot be losing much from its large welfare state.

### ***We Are Not Done Yet***

Unfortunately, even though it contains the *germs* of some important truths, the theory of efficient redistribution is in large part wrong. We still have a ways to go to get an answer to our second question of why Sweden isn't worse off.

To see what is wrong about the theory of efficient redistribution - and even to isolate the elements of truth in it - we need a new conceptual framework. To construct this framework, we shall need a number of different ideas, including the distinction between explicit and implicit redistribution that has been developed in this chapter.

The new conceptual framework is presented in the next two chapters. Some of the

concepts in this framework are new and others are drawn from my books on *The Logic of Collective Action*<sup>5</sup> and *The Rise and Decline of Nations*. I shall endeavor to present the argument in such a way that it will involve very little repetition for those who have read these books, yet be comprehensible to those who have not. When this framework is complete, we will not only be able to see what is right and wrong about the theory of efficient redistribution, but we shall also be able to look at modern Sweden from a new angle.

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<sup>5</sup> Cambridge, Mass.: Harvard University Press, 1965.