

1981

MASON GAFFNEY

Economic Policy Analysis
3040 Tyler Street
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June 25, 1981

Dear Polly:

I enjoyed your latest, as usual. What is the audience to be? I have some comments.

1. The title is low-key and hard to remember.
2. Some footnotes and citations would be useful, especially with some of your anti-cliches.
3. I, too have been fooling around with Fortune's 500-1000. See enclosed.
4. It seems to me your best audience is college students. I will use this in class next fall. Your style is too sober and soft-sell for the presses, and too straightforward for the journals. But students should get it.
5. p.19. a) With inflation this year around 10%, and some int. rates around 20% (e.g. the prime) I wonder if the "true" rate of interest is 2-4%? And, if there is a 7 point spread, what is this "true" rate? This needs more careful statement.
b) Are you saying that inflation raises the real spread of the i.r. structure? If so, that's pretty profound, and worth an article.
6. Your use of the Becker material, p.20, is very clever.
7. p.21, 4th para. needs clarity. Even I am not sure what you mean. Suddenly the housekeeper is going to high school? We have a real problem explaining why so many little people have sat still for crumbs at 5%. I am glad you make the effort, but better make more.
8. p.24, citation needed re Japan.
9. p.25, "spent rockets in the upper class orbit" -- memorable!
10. 40 acres and a mule was a freedmens' demand after 1865. It was never met.
11. Is the South still the least egalitarian region? Current data needed. Lots of little farmers in N.C.
12. Please send me citation to study based on 1970 Census, p.28.

I have just finished a short report to Alaska, coming separately.

How about your Ph.D? You may run out of time. You could always transfer down here for a more sympathetic final hearing, if need be.

We have a loan out at 19% to a local real estate tycoon. It is to carry raw land, which banks cannot lend on. He could have paid it off any time in the last 12 mos., but didn't. Now it is due and payable, and we offered to extend it at 22%. He refused, but he hasn't paid it off either. Today I am going to the mat with him. The raw land is worth lots more than the loan, and we have a first trust deed. He has had two weeks to find other money, and evidently hasn't. Signs of the times.

By the way, short money is currently much higher than long. I think it is on long-term loans that the rich do so much better than the poor.

Keep hitting the ball.

Love,

Mase

Polly Roberts
C/o Robert Cleveland
West Chop, Mass, 02573

Saturday, July 25, 1981 (New York)

Dear Mason,

Thanks for your letter and your valuable comments. I have duly incorporated them in my latest version. I will send you a copy at some point.

I wrote the thing for a semi-popular magazine. It bombed at Atlantic "much too dry and theoretical" --so now I've sent it to Commentary, that hotbed of neo-conservatives. Next I'll try Public Interest, and after that, who knows?

Your enclosed twiddlings with the Fortune 500 were only allegedly enclosed. Please send.

Why do poor folks put \$1000 in a savings account at negative interest? There's a good answer in the sociological literature: they're buying disaster insurance. They keep a little hoard of cash--a "rainy day fund"--for emergencies like loss of a job or sudden medical expenses. They don't care about interest, they don't even understand interest. A savings bank is just a safer place than a mattress. (Til the next crash.)

I've enclosed the piece with the info about people with negative income averaging a net worth of \$70,000 or so. Unfortunately I seem to have misplaced the card with the complete citation.

We're staying in New York. Keith has finally convinced his brothers to sell their share of the company to him. So now at last he has control. He's absolutely ecstatic. He spends every evening and weekend at his computer, generating reports, projections, etc. It's a wonderful opportunity for him. I'm sure he can turn the place around in a year or less, now his brothers can't mess things up any more. But we'll miss California.

I've been in New York this last week, hastily assembling what I've completed to date on my thesis, to ship to Peter. I hope he'll take it as is. (I'll see him mid-August when we go out to pack our stuff.) I've been frosting the cake much too long. Close to 450 pages. Ug.

Assuming Peter accepts it without much fuss, and the others sign without reading (standard practice at Berkeley I gather), --I'll look for some sort of fellowship in some institute around here to turn it into a book. Not for the money, but because I've been working alone far too long. I need feedback.

Do you ever get back east? How many years since I've seen you?

Love,

Polly

9.1 The Wealth--Transaction Cost Hypothesis

weat "[T]he tendency of what we call material progress is in nowise to improve the condition of the lowest class in the essentials of healthy, happy human life... It is as though an immense wedge were being forced, not underneath society, but through society. Those who are above the point of separation are elevated, but those who are below are crushed down".

Henry George, Progress and Poverty (1879), p. 9.

The wealth--transaction cost hypothesis holds that transactions costs drive a "wedge" between richer and poorer persons, much like a trade barrier. Consequently, richer persons find capital relatively cheap and abundant, and labor relatively scarce and expensive; poorer persons find the opposite. So, within the same economy, richer and poorer persons face characteristically different sets of opportunities. Suppose richer and poorer people have identical sets of preferences. Then a great many other differences in economic behavior follow from their underlying difference in factor proportions and prices. Part I Chps. 1-5 works out some of these differences mathematically.

The wealth--future-orientation *hypothesis* is completely independent of the wealth--transaction cost hypothesis. It holds that wealthier persons have more future-oriented time preferences: at a given rate of exchange, they give up proportionally more present consumption for future consumption. So richer and poorer people have different sets of preferences. Given the wealth--transaction cost hypothesis, the wealth--future-orientation hypothesis proves necessary to account for the stability of unequal distribution over time. Without the wealth--future-orientation hypothesis, only equal distribution could be stable. Chapters 6 and 8 model mathematically the combined wealth--transaction cost and wealth--future-orientation hypotheses.

Together, the wealth--transaction cost and wealth--future-orientation hypotheses provide a complete, self-contained model of the distribution of wealth and income, easily encompassing and completing the human capital model of Gary Becker and others. (Gian Sahota argues in a review of personal income distribution theories that the human capital model's greatest weakness is its omission of inheritance and determinants of ability, particularly preschool investment -- a gap filled here. [Sahota, 1978, p. 32.]

An increase in future-orientation with wealth ~~magnifies~~ ^{magnifies} the differences in behavior between richer and poorer people due to transactions costs. That is, if richer and poorer people differ in preferences as well as opportunities, they then differ more sharply in costs of labor and capital, ~~and all that follows~~. This poses no problem for testing the wealth--transaction cost hypothesis, because labor and capital costs cannot differ without transactions costs. However, tests for the wealth--future-orientation hypothesis (apart from the obvious test of stability of unequal distribution) prove more elusive, though not impossible.

The following sections examine the literature for theoretical and empirical arguments pro and con the wealth--transaction cost and wealth--future-orientation hypotheses.

POLLY ROBERTS
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(212) 724-6697

Monday, July 13, 1981

Editors
The New York Times
229 West 43rd St.
New York, N.Y., 10036

Dear Sirs:

I am submitting the enclosed "Tax Breaks for the Rich May Slow Economic Growth" for your Op Ed page. It's based on my almost-completed dissertation for a PhD in economics from the University of California, Berkeley.

For your information, I have also enclosed a piece I wrote on a different topic, published in the Washington Star.

After the 17th, I can be reached on Martha's Vinyard:

c/o Robert Cleveland
West Chop, Mass., 02573
(617) 693-1321

Sincerely,

Polly Roberts

TAX BREAKS FOR THE RICH MAY SLOW ECONOMIC GROWTH

Poorer people and smaller companies invest their capital more productively than richer people and bigger companies. Consequently, the Reagan tax proposals, which will redirect capital from the former to the latter, may reduce economic growth.

Richer people and bigger companies do save and invest more of their income. That's why the Reagan Administration expects that shifting the tax burden off them will stimulate economic growth. But economic growth depends not only on the quantity of investment, but also on the quality, as measured by return. An investment at zero return obviously adds nothing to growth. An amount invested at, say, 20%, contributes double of that invested at 10%.

So if poorer people and smaller companies get a higher return on investment than richer people and bigger companies, they contribute proportionally more to national growth than their savings rate suggests.

But do poorer and smaller really get higher returns? Conventional economists would answer, "Obviously, yes." For poorer and smaller have relatively little capital to begin with, and face serious obstacles to borrowing more (a phenomenon economists call "capital market failure"). So, just as desert-dwellers use water very carefully, poorer and smaller reserve their scarce capital for the most productive investments.

Non-economists, however, often have trouble grasping why poorer and smaller should get higher returns. The difficulty arises from the fact that, of course, richer people get higher cash returns from stocks and bonds than poorer people get from savings accounts. For example, in a survey of returns on financial investments of Wisconsin individuals in pre-inflation times, low income investors averaged a cash return a bit

under 4%, while high income investors averaged a bit under 7%.

But cash is only part of the return on financial investments. While richer people may invest in stocks and bonds primarily for income and appreciation, poorer people keep a "rainy day fund" in a savings account primarily for emergencies. In addition, financial investments are relatively unimportant to poorer people. They do the bulk of their investing either in acquiring education and skills--"human capital"; or in building up small businesses or improving small property--"sweat equity."

There is much solid empirical evidence showing poorer people and smaller companies do in fact get considerably higher returns on investment.

Differences in interest rates for borrowed money provide indirect evidence. For it is generally accepted economic theory, and just common sense, that people and companies get returns on investment comparable to the cost of borrowed capital. In borrowing from banks, rich people and big companies may pay rates as low as one point below prime. Poorer people and smaller companies may pay up to six points over prime, if they can get a loan at all. Installment buyers may pay a real 18% or more. And those poor people and small businessmen desperate enough to resort to loan sharks may pay 40% on up.

Some direct evidence comes from measures of return on investment in education. For example, economist Gary Becker estimates that a college education returns 13-15% over a lifetime, or 11-13% allowing for the greater average ability of college graduates. He estimates around 18% for a high school education. Various other estimates put returns on 8th grade education as high as 40%, and returns for postgraduate education even lower than those for college.

Differences in ability don't explain the differences in return, --quite the contrary. If college-educated people are generally more able, all else being equal they should get a higher return than high school graduates.

So, as economists making these estimates recognize, the fall in rate of return with years of education stems entirely from poorer people's difficulty obtaining capital. Poor families cannot find the capital to tide themselves and their children through school and college. Meanwhile, well-to-do families can support their children through six years' graduate school finishing a PhD in English--which may add not a whit to their earning power.

These and other figures suggest that very rich people and big companies average real returns on investment no higher than 8%, probably much less. Middle class and smaller companies may average 10-15%. Working and lower class people, and very small companies may average from 16% on up.

Consequently, while poorer people and smaller companies save and invest a smaller percentage of each dollar of income, their higher returns mean they may contribute as much or more per dollar of income to economic growth.

Other kinds of evidence also suggest middle class people and smaller companies contribute proportionally more to growth. For instance, small inventors make virtually all major new inventions. Small companies make most of the new oil strikes. Despite his predilection for the upper classes, George Gilder spends chapters of Wealth and Poverty celebrating the creativity and productivity of rags-to-riches immigrants or the young scientists of the booming microprocessor industry.

In any case, all this evidence undercuts the Reagan Administration's claim that tax breaks for richer people and bigger companies will boost national growth. Such tax breaks may increase the amount of saving and investment, by giving more income to the higher saving rich people and big companies. But, by reducing the income of the higher return middle and poorer classes and smaller companies, the Reagan tax program may lower the quality of investment enough to slow economic growth.

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Sunday, July 26, 1981

Dear Peter,

Here it is, some 430 pages. But you don't have to read the math. You only need read the Introduction (which includes the review of literature), the A and B sections of Chps. 1-8, and if you're feeling ambitious, Chp. 9. It's still rough in places, and some of the entries in the Bibliography are incomplete. But I think it hangs together.

You'll see on reading the introduction why I've had such trouble finishing: the basic model has so many implications for so many fields of economics that I've found it hard to resist pursuing at least the most obvious ones. The manuscript I've sent you contains no discussion of evidence on risk or the theory of the firm--which is what I did most of my earlier work on. I was planning to write that stuff up this fall.

Assuming you and Andy and Bardahn accept the thing without massive revisions and additions, I'd like to find someplace around N.Y. that would give me a fellowship to turn it into a book. Any suggestions?

As of Sept. we're moving to a new apt to be closer to Abigail's kindergarten:

2166 Broadway, Apt. 6-B
NY NY, 10023

See you and Jan in August.

Love,

Polly

INTRODUCTION

Does the distribution of wealth affect output, wages, investment, growth, the distribution of firm size, and other features of an economy? If so, how?

How does economic behavior differ between richer and poorer individuals, or larger and smaller firms? What accounts for the stratification of populations into social and economic classes? What causes geographic patterns of wealth and poverty?

What makes unequal distribution of wealth so universal and persistent?

How much redistribution of wealth or income is desirable, or possible? Must "equity" necessarily conflict with "efficiency"?

Questions about the consequences and causes of unequal distribution seem to resist standard neo-classical analysis. Many economists have therefore resorted to ad hoc treatments of parts of the distribution problem within specialized fields, such as regional development or labor economics. Or they have abandoned neo-classical analysis altogether for apparently more relevant and humane Marxist approaches.

I propose on the contrary to treat the distribution of wealth in the now-popular framework of property rights. Thus, a given distribution of wealth in an economy with transactions costs is an allocation of property rights with consequences easily derived by marginal methods.

This approach proves most fruitful. It resolves some long-standing theoretical problems, in fields ranging from location theory to the behavior of the firm. It explains a number of awkward "facts" that have seemed to discredit neo-classical theory. And it yields an abundance

of testable hypotheses, some obvious, a few quite surprising.

Finally, this approach offers some hope -- hope that economic problems may not prove so intractable as the fashionable pessimists of the "zero-sum" school would have us believe.