The New York Times
nytimes.com

April 25, 2010

The Tax Hiding in Your Paycheck

By ROBERT H. FRANK

EVERY year at tax time, libertarians indignantly denounce government income transfers from rich to poor. Society's income distribution, they argue, should reflect as closely as possible what people would earn in unregulated private markets.

When critics on the left counter that income transfers are required in the name of social justice, libertarians yawn — and the debate goes nowhere.

There is a more fruitful way to look at the issue. Suppose, for the sake of discussion, that we grant the libertarian premise that private pay systems provide the best ethical template for society's income distribution. As closer scrutiny of that premise will make clear, the libertarian denunciation of income transfers fails on its own terms.

The main problem is that private pay patterns embody an implicit tax that is actually far more progressive than the federal income tax. To understand why, first consider some background about the way these patterns work.

Economic theory holds that in competitive labor markets, workers are paid the market value of what they produce. In actual markets, pay does rise with productivity, but not by much. The most productive carpenter in a framing crew, for example, might produce twice as much as his least productive colleague, but is rarely paid even 30 percent more.

To see the pattern at first hand, consider groups of co-workers who perform similar tasks in your own company. In one case, suppose that your two most productive co-workers leave the job; in the other, suppose that the three least productive leave. Which group's departure causes a greater loss of value? Most people would answer that losing the top two hurts more.

If so, economic theory holds that their combined salaries should be higher than the combined salaries of the bottom three. Yet the typical pattern is the reverse: any three workers in a group performing similar tasks earn substantially more than any other two.

In short, the startling fact is that private businesses typically transfer large amounts of income from the most productive to the least productive workers. Because labor contracts are voluntary under United States law, it would be bizarre to object that these transfers violate anyone's rights.

But they do raise an interesting question: If the most productive workers in a group are paid less than the value of what they produce, why don't rival employers just lure them all away?

One answer is that these employees may care, often subconsciously, about things besides pay. The most productive workers in a group, for example, often appear to value their status, perhaps because they enjoy greater self-esteem and respect than the least productive workers. To bid successfully for the high achievers, a rival employer might not only have to increase their pay, but also place them in a group where they continue to enjoy a high ranking.

In a free market, however, no one can be in the top half of any group unless others agree to be in the bottom half. And if people prefer not to occupy low-ranking positions, filling these positions would require extra compensation. The rival's offer, then, would resemble the original pay pattern.

The upshot is that top-ranked workers may well stay put. The high ranking they enjoy is more than enough to offset their sacrifice in pay. Similarly, their less productive co-workers may find it onerous to be at the bottom of the ladder, but they are compensated for that fact by their premium wages.

So, in effect, private markets are already applying an implicit progressive tax in the way they pay workers. And, in the process, they serve the interests of everyone in the hierarchy. The alternative would be costly social fragmentation.

CAN anyone doubt that high rank has value, not just among groups of co-workers but also in society? For starters, high-ranking members of society, who also tend to have the highest incomes, know they will be able to send their children to the best schools and have access to the best health care. Low-ranking members enjoy no such confidence.

It's much harder, of course, to organize new societies than to start new businesses. But that doesn't mean high-ranking positions in the real world should be available at no cost. They are possible only when others bear the costs associated with a low social ranking.

Tax systems that transfer income from rich to poor, thus mimicking the implicit transfers in virtually every private labor contract, reflect the costs and benefits of different rungs on the social ladder. They help make stable, diverse societies possible.

Enlightened libertarians believe that the best social institutions mimic the agreements people would have negotiated among themselves, if free exchange had been practical. Private pay patterns suggest that our current tax code meets that test.

Robert H. Frank is an economics professor at the Johnson Graduate School of Management at Cornell University.