4-26-2021

Matthew Dimick, Using Legal Rules to Reduce Income Inequality

Matthew Dimick
University at Buffalo School of Law, mdimick@buffalo.edu

Blog 14

Matthew Dimick, Using Legal Rules to Reduce Income Inequality

Blog Author: Matthew Dimick, Professor, University at Buffalo School of Law

Introduction: The United States has experienced a disturbing expansion of income and wealth inequality in the past three or four decades. We only fully recognized this yawning divide in the material fortunes of Americans after the 2008 financial crisis, which did little to change the direction of the trend. The Coronavirus pandemic has only added fuel to the inequality fire in a particularly grave way. Income inequality might be condemned on its own terms and for its political (erosion of democracy) and economic (financial instability) consequences. These worrisome trends in economic inequality have caused scholars to look for policy solutions. For legal scholars, in particular, the question arises: can legal rules do anything about income inequality? A long-standing position within law-and-economics scholarship gives a clear answer to this question: No.

Using Legal Rules to Reduce Income Inequality

Blog Author: **Matthew Dimick,** Professor of Law, School of Law, University at Buffalo

Keywords: Income, Income Inequality, Inequality, Wealth, Finance, Financial Crisis, Coronavirus, Political, Economic Consequence, Policy, Solutions, Tax, Redistribution, Rich, Poor, Labor-supply, America, Double Distortion, Free Market.

The United States has experienced a disturbing expansion of income and wealth inequality in the past three or four decades. We only fully recognized this yawning divide in the material fortunes of Americans after the 2008 financial crisis, which did little to change the direction of the trend. The Coronavirus pandemic has only added fuel to the inequality fire in a particularly grave way. Income inequality might be condemned on its own terms and for its political (erosion of democracy) and economic (financial instability) consequences.

These worrisome trends in economic inequality have caused scholars to look for policy solutions. For legal scholars, in particular, the question arises: can legal rules do anything about income inequality? A long-standing position within law-and-economics scholarship gives a clear answer to this question: No. This answer finds its clearest expression in Louis Kaplow and Steven Shavell's classic 1994 article, "Why the Legal System Is Less Efficient than the Income Tax in Redistributing IncomeDownload pdf."

In this article, Kaplow and Shavell argue that legal rules should be chosen only based on efficiency—making the economic "pie" bigger—and never based on distribution—how the economic "pie" is divided. The reason for this, Kaplow and Shavell explain, is the income tax can always redistribute income more efficiently—that is, with less waste—than can legal rules (which they understand as all legal rules *other* than those used in the income tax system).

For example, say we have an income tax rate on the rich of 30 percent and want to redistribute an additional 1 percent of income by adopting a tort rule that makes damages dependent on the defendant's income. The damages a rich person will have to pay will be more than a poor person for an accident that otherwise causes the same harm. This rule has two effects. The effect on the income of the rich distorts labor-supply incentives just as a 1-percent increase in the tax rate would. But it *also* generates inefficiencies in the amount of care the rich take, which in this case spend too much time and resources on taking precautions against accidents.

As Kaplow and Shavell point out, this second distortion is pure waste. Rather than adopt a tort rule that redistributes an additional 1 percent of income, but with additional waste, we should instead simply increase the income tax rate by 1 percent. This will achieve the same amount of redistribution that the tort-damages rule does, and because it saves on resources, those savings can be used to reduce taxes on everyone or increase transfer payments to the poor. The switch from the tort rule to the income tax can make *everyone* better off. Despite using this particular example, Kaplow and Shavell claim that their insight is quite general. Any legal rule used to redistribute income will have two negative effects—a "double distortion," it has been called—whereas the income tax will only have one.

A book that I am currently working on, *The Law and Economics of Income Inequality*, critically examines this and other arguments against using legal rules to redistribute income. One argument the book makes is that, while Kaplow and Shavell's particular example may be right, their argument is not as general as they make it out to be. One reason for this is that using legal rules to redistribute income sometimes creates not two but three distortions, and this third distortion *offsets* rather than adds to the economic waste.

As an example, consider intellectual property law. Suppose we start from an efficient IP regime and want to change it to address income inequality, say by reducing patent length or narrowing patent scope. Such a change will have two effects. Reducing the monetary rewards of holding a patent will have the same effects on labor supply as a tax would. It will also distort the incentives to invest in R&D and other inventive activities.

So far, this tracks exactly Kaplow and Shavell's objection. But there is a third distortion: reducing patent length or narrowing patent scope also increases product-market competition. More importantly, this distortion adds to rather than detracts from efficiency, so it moves in the opposite direction from the previous two distortions. Because of that offsetting effect, the new IP law can be more efficient—or, more accurately, *less inefficient*—than the income tax in redistributing income! Kaplow and Shavell's argument fails to appreciate the existence of this third effect and its direction, so their claim is not as general and policy-relevant as they think it is.

There is a traditional and long-standing concern against intervening in the "free market," whether for reasons of freedom, utility, or efficiency. Kaplow and Shavell's double-distortion claim for using the income tax rather than legal rules to redistribute income is simply one of the more recent arguments in this enduring inclination. However, in confronting income inequality, we shouldn't avoid using any tool available to address this important problem. My research suggests that legal rules can indeed be used to mitigate income inequality.