The relative efficiency of private and public transfers*

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1. Introduction

Two interrelated arguments are often used to defend public income transfer programs. The first is that even a well-functioning market system is unlikely to achieve a 'fair' income distribution. The second is that a 'fair' income distribution can be viewed as a public, or collective-consumption good. The first argument provides a justification for non-market institutions to redistribute income; the second provides justification for public income transfer programs.

However, the traditional rationale for public redistribution programs is founded on a somewhat asymmetric treatment of the public and private sectors. The public sector is often assumed able to impose appropriate benefit taxes to finance transfers, while the private sector is assumed to face serious obstacles in overcoming the free-rider problem. This comparison is not particularly realistic because of the rather formidable informational requirements associated with actually levying benefit taxes. A more realistic comparison would be between competing public and private arrangements, each with its own strengths and weaknesses. The comparative weakness of private charity is that because of free-rider behavior, some externalities resulting from income redistribution will tend to be ignored. However, because contributions are voluntary, any income transfers which are made will reflect donors' private valuations of giving. In contrast, public institutions are more apt to take externalities into account, and because 'tax contributions' are compulsory, taxpayer-donors are less able to free-ride. But, because information about the distribution of benefits is imperfect, taxes will only imperfectly reflect the private and social benefits received by individual taxpayer-donors.

This juxtaposition of institutions raises the following question: Under what conditions will a system of voluntarily financed income transfers be at

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least as efficient as a system of publicly financed transfers? The public
goods literature has recognized that the welfare gains from public provision
of quasi-public or even purely public goods may be less than implied by the
simple textbook model. However, the discussion has seldom progressed
beyond recognition of imperfections in the financing of public goods which,
depending on the author’s viewpoint, are either (a) implicitly assumed to be
sufficiently minor relative to private sector imperfections so that public pro-
vision is Pareto-superior, or (b) implicitly assumed to be serious enough to
warrant reliance on private finance.

These discussions are missing a formal theoretical framework for com-
paring the relative efficiency of public vs. private financing of collective
consumption goods. Though Spann (1974), Usher (1977), and Wilson and
Katz (1983) model the choice between public and private financing of private
goods, for private goods the comparative advantage from public financing is primarily distributional, not allocative. Thus, the question is
not how to provide the good more efficiently. Rather it is what factors affect
the propensity to vote for ‘socialization’ of goods which presumably could
be provided efficiently in private markets?

The principal objective of this paper is to develop a model which can be
used to analyze the relative efficiency of privately-financed as compared to
publicly-financed transfers. Though the specific topic is income transfer
programs, the model is sufficiently general so that it is applicable to the
general issue of public vs. private financing of collective consumption
goods.

The paper proceeds as follows. We first present a model of private giving
in which the equilibrium level of transfers is determined by the separate deci-
sions of utility-maximizing donors. We then develop a model of public
transfers in which the government attempts to provide the socially optimal
amount of redistribution, but cannot in general achieve this optimum
because it has imperfect information about donor preferences. In general,
it is impossible to determine on theoretical grounds alone whether publicly
financed redistribution necessarily leads to more redistribution or higher
social welfare than privately financed redistribution. Based on plausible
assumptions about the distribution of donor preference parameters, we
therefore simulate the impact of each transfer system. These simulations
identify conditions under which private redistribution is likely to increase
the welfare of donors more than will government-financed redistribution.²

2. Private redistribution

We assume for simplicity that there is a target population of fixed size who
are potential recipients of either private or public transfers. These transfers