Economics, Equity and Urban-Rural Transfers

SIPP Public Policy Paper No. 7

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Prepared for the conference

Rural Canada: Moving Forward or Left Behind?
(22-24 November 2001)

Saskatchewan Institute of Public Policy, December 2001

Introduction

Suppose that changing technology, patterns of trade, and prices have created a situation that, left unchecked by decisive government action, would result in a migration from rural to urban areas. Should the government take an active role to discourage migration, through subsidizing agriculture either through direct payments or through the provision of infrastructure that otherwise would not pass a standard cost-benefit test? Should the government provide such social goods as hospitals and schools to rural areas to a degree unwarranted by the population distribution, again in an effort to stem the flow of migration from rural to urban areas?

A recent example of the kinds of policies I have in mind is provided by the 2001-02 budget of the province of Saskatchewan. In a section on “Saskatchewan’s Strategy for Rural Revitalization” (Saskatchewan Finance, 2001: 29-31) the government promises $9.6 million in rural capital projects from the Canada-Saskatchewan Infrastructure Program, enhanced internet services to rural communities and schools, “targeted measures” to attract immigrants to rural Saskatchewan, an increase in small business loans, funding for Regional Economic Development Authorities, and boasts of the fact that Saskatchewan provides more taxpayer support for agriculture, per capita, than any other province and more than three times the support of the federal government, not counting the various provincial tax breaks for the sector. Saskatchewan has also established a Rural Revitalization Office to coordinate efforts across line departments.

This paper seeks to assess such policies from the perspectives of efficiency and equity. The analysis is at a high level of generality; hopefully this will allow for greater clarity as to what are the key conceptual issues from an economist's vantage.

Efficiency

No one can live on the prairies without being aware of the enormous changes that have occurred in agriculture over the past century. Great increases in productivity have contributed to an ongoing decline in the relative price of agricultural products, and subsidy programs, especially in the United States and the European Union, have exacerbated the increases in the supply of products and the resulting decline in prices. A natural consequence is that fewer individuals work in the agricultural sector.

Although the situation is often described in terms of the "fall in income" among farmers we must be careful to specify exactly what we mean by that. So long as labour is a mobile factor of production, it will migrate to where it can earn the highest income, income being broadly defined. In equilibrium the distribution of population would be such that no one was left with any incentive to relocate. If incomes declined in the rural areas, individuals would migrate to cities. Assuming the usual diminishing returns to factors of production, this should cause the average income in rural areas to rise, and incomes in urban areas to fall, until incomes are equalized between rural and urban areas. If agricultural prices are in a continual, long-term decline, we would expect to observe continual migration. So the inequalities are not permanent, given mobility. As Hendrik Houthakker (1967: 7) put it: "The greater the increase in farm productivity, the greater the imbalance between supply and demand of farm products which has to be corrected by an outflow of labor or by lower farm prices. *Unless the outflow of labor from farming is fast enough*, an increase in farm productivity leads only to lower farm prices and lower farm incomes" (emphasis mine).

Note that in our story so far, migration is a good thing. Migration is efficient in that labour is moving from a lower-valued to a higher-valued activity, so the total income of the population will be rising. This gives rise to the economist's perspective, which some might see as hard-hearted, that inequality in incomes is not altogether a bad thing; inequality is the signal to workers in low-income activities that they might want to try an alternative. For example, Welch (1999) notes that the increasing wage-differentials based on education levels have had the positive role of attracting more investment in education. The role of prices and wages in an economy are not to serve as rewards for what has already been done, but rather to serve as signals for what should be done next.

Rural-urban migration has been going on for a very long time, around the world, in response to shifting economic opportunities. The migration was slower in the twentieth century than in the nineteenth, as urban clusters became less important for manufacturing. The greater use of plastics and nonferrous metals, and transportation networks more flexible than the main rail lines, and innovation in electric power generation and transmission, all played a part, as did the preference of many families for aspects of the rural lifestyle (Easterlin, 1980: 310-1). Still, this was a slowdown in the general pattern, not a reversal (reversals of the migration pattern *have* occurred temporarily, but only in the event of an extreme economic downturn of the magnitude of the 1930s).

But the most challenging task for economists studying rural-urban migration is to explain why it has not occurred faster. Farm incomes are *chronically* low - labour and capital earn lower returns in farming than in alternative uses on what seems to be a perpetual basis - and so there remains the question of why, in Houthakker's phrase, the outflow of labour from farming is not fast enough. Gardner's (1992: 76) extensive survey of the literature finds

> it doubtful that the present differences between farm and nonfarm wages are a matter of disequilibrium; they are more likely a compensating differential for skill differentials or nonwage aspects of the two employments. While a full explanation of these observations has not been accomplished by research to date, it seems likely that the traditional farm-problem source of trouble - declining demand for farm labor owing to technical progress in agriculture - is not the explanation of relatively low farm wages.[1]

[1] Prior to the modern economy it was thought that rural labour had *superior* skills to urban workers, although Gardner's survey suggests those days are past. One eighteenth-century observer of the economy found: "Not only the art of the farmer, the general direction of the operations of husbandry, but many inferior branches of country labour require much more skill and experience than the greater part of mechanick trades. …The common ploughman … is less accustomed, indeed, to social intercourse than the mechanick who lives in a town. His voice and language are more uncouth and more difficult to be understood by those who are not used to them. His understanding, however, being accustomed to consider a greater variety of objects, is generally much superior to that of the other, whose whole attention from

Of course not all rural residents are farmers, and in this analysis we are concerned with migration from rural areas in general, not just off the farm. But it is still worth stressing that the key economic issue is mobility.

In a simple model of the economy there is no policy problem with rural-urban migration, unless there are artificial barriers to people moving to where their incomes and opportunities are highest. But that leads us to the question of whether our world, in some relevant way, is different from the simple world of supply and demand diagrams. At the foundation of all economic policy analysis is the theoretical result that in the absence of spillover effects, or "externalities", competitive markets will generate an efficient allocation of resources, maximizing our aggregate incomes. Interventionist policy is justified, on efficiency grounds, only when there is evidence that (1) there are externalities or noncompetitive aspects, and at the same time (2) there is a feasible, practicable government policy that could improve matters.

One suggestion commonly made is that the ordinary analysis of efficient migration does not apply because the migration is being driven by policy choices in the United States and the European Union that through the persistent use of large subsidies artificially depress the returns to agriculture in Canada. If there were some indication that these subsidies were temporary there might be a rationale to subsidize agriculture in Canada, on the grounds that we could prevent instability until prices returned to their expected long run values. As it turns out, there is no indication at all that the US and EU are taking temporary measures. They will continue to subsidize in a substantial way, and

morning till night is commonly occupied in performing one or two very simple operations" (Smith, 1981 [1776]: 143-4).

this will lower world agricultural commodity prices below what they would otherwise be. But this is *not* a rationale for Canada to stem rural-urban migration through rural/agricultural subsidies. If world commodity prices are low, they are low, and in terms of the efficient allocation of Canada's human and capital resources it doesn't matter how the low prices got that way. We misallocate our factors of production, and lower our total income, if we make policy decisions based on some notion of "true" commodity values that we simply don't, and never will, actually receive through the market. It is an elementary economic point, but worth raising given how often media commentators get it wrong.

In the economics literature on regional economic policy two types of externalities are raised that could, in principle, lead to a justification of subsidy to rural areas: market failures in labour markets, and the problem of urban congestion (Armstrong and Taylor, 1978). We deal with these in turn. However, what we will find is that neither of these potential externalities are noticeably evident in Canada's current urban/rural mix.

Consider first the seminal work of Harris and Todaro (1970); if there are imperfections in the urban labour market leading to substantial involuntary unemployment, there may be an amount of rural-urban migration that is inefficiently high. People would migrate from rural areas based on the *expected* wage in the urban area, which is the product of the urban wage, perhaps being maintained by policy at artificially high levels, and the probability of actually obtaining a job at that wage. They show that a restriction on migration (about which Harris and Todaro express ethical concerns) could potentially increase national income, although it would harm the rural economy at the expense of the urban and some equalizing transfer might be required. In our full employment, diversified economy the problem identified by Harris and Todaro is unlikely to occur, and so their model has not provided us with an efficiency justification in *this* economy for trying to slow migration from rural areas. Bartik (1994) and Courant (1994) also raise the point that involuntary unemployment in a particular region could at least potentially justify government action to spur regional economic development. In their case the labour market failures are where people are leaving, not where they are arriving. But Bartik and Courant are discussing a situation of labour markets simply failing to clear, where there are idle workers who would accept jobs at even less than the going wage rate for their skills if only there were jobs available; a case more applicable to the "rust belt" American urban midwest than rural Canada. Courant (1994: 875) still warns of the fact that "policies designed to shore up such places as old whaling villages and mill towns must fail if they are based on subsidizing increasingly unproductive activities. There may be a high willingness to pay to ensure a way of life in a place of one's choice. Providing effective insurance of this kind, at any price, is something that we simply do not know how to do."

The second type of externality that might arise through rural-to-urban migration results from the congestion of public goods in urban areas. A well known problem with some public goods such as roads and other public infrastructure is that if it is prohibitively expensive to impose user charges there can result an overuse of such facilities. If public infrastructure in rural areas is relatively *under*used, there might be a justification for discouraging the typical migration pattern (Bartik, 1994). However, it's not clear that this is a problem that is present in the current Canadian context. Fiscal pressures on Canadian provinces during the past twenty years have generally led to an underinvestment in infrastructure, such that the problem now facing provincial treasuries is not underused capacity, but instead the decision of where replacement infrastructure is most needed. And there is no indication that increased investment in rural infrastructure is justified on the ground that rural Canada is where the marginal value of such investment would be highest.

None of the above should be taken to imply that public policy needs to be directed at boosting the level of economic activity in cities. Following Paul Krugman's (1991) path-breaking essay, the field of economic geography has taken on new life. Economists have long thought that increasing returns to scale might explain many economic phenomena, but only recently have theoretical techniques been developed that allow us to model the implications, and this has led to "new" growth theory, "new" trade theory, and, for our purposes, "new" economic geography. Much of this new work centres on the implications of the increasing importance of "knowledge" as an input in production. If knowledge is prone to substantial positive externalities across economic activities - i.e. "knowledge spillovers" - and these externalities depend on close geographical proximity, then we would be likely to see an increased movement of economic activity from rural to urban areas (Audretsch, 1998). But this research is still at a very early stage, and Krugman (1998) himself is extremely cautious about how we might go about modeling economic policy in such a framework. It is certainly not yet obvious that active policy through subsidy to urban centres is required (Fenge and Meier, 2001). The recent claims by the Canada West Foundation (2001: 17-18) - "The major metropolitan regions are the [Canadian] West's gateways to the new global economy and primary motors of economic growth. The prospects for regional prosperity depend on an explicit and effective urban strategy by all governments active in the region" - are premature.

To summarize this section, changes in technology, relative prices, and trade patterns have led to a situation of migration from rural to urban areas, and as long as this movement is relatively unimpeded, the migration is generally efficient in that it equalizes the marginal value of factors of production across different employments. Rural depopulation does not mean that living standards in rural areas are falling. To the contrary, the migration is the means by which rural incomes remain somewhat level with other incomes. Although we don't live in a perfect economics-textbook world, the major externalities that have been sometimes associated with rural migration are not significant in our time and place, and government intervention in "revitalizing" the rural economy is highly unlikely to be efficient.[2]

Equity

Efficiency is not the only thing that matters. As well as the total amount of wealth being created, we are also concerned about its distribution. It is a commonplace assumption in the economics of welfare that as a society we are willing to sacrifice some efficiency if it means creating a more equal distribution of income or opportunity. A progressive income

[2] Note that I have not raised the multitude of problems that arise in translating an identified market failure into an effective government policy that actually deals with the economic problem at hand. "Public choice" failures in rural and agricultural policy are legion, and the political economy of massively inefficient government policy towards agriculture fills too many volumes of research to list here.

tax is but one example of a case where there is a generally accepted willingness to sacrifice some total wealth in an effort to transfer from the rich to the poor.

But in general the income transfer programs we enjoy are based on personal circumstances of the individual or family independent of where the transfer recipient lives.[3] What we want to ask in this essay is whether we could ever justify subsidization of the rural economy on the basis of the redistributive aspects of the policy, even if at some cost in efficiency terms.

Canada has an extensive welfare state that involves redistribution both in terms of pure income transfers and through the provision of services such as health care and education to all funded through a progressive tax system. Is there an *additional* aspect of the welfare state that needs consideration, beyond all the existing transfers, that would subsidize individuals or families who see a declining economic standard of living where they currently live?

No one would deny that moving is costly in monetary and psychic terms, more so if one has a particular attachment to where he currently lives.[4] Note that the existence of such costs do not invalidate the general result that migration of labour and capital results in an efficient allocation of resources. For example, if a move from country to city would cost Tom $2,000 in monetary and psychic terms, and yield an increased wage which

[3] There are exceptions to this rule. For example, the Personal Income Tax contains an allowance for those living in the far north, to compensate them for the very high cost of living.

[4] See Bartik, Butler and Liu (1992) for means of econometric estimation of the value of a “sense of place”, and Kahneman, Knetsch and Thaler (1991) for general discussion of the “endowment effect”. Bliss (1993) notes the problems in trying to make welfare evaluations at all if migration causes a change in the migrant’s values and preferences.

would yield a stream of future income $1,800 more in present discounted value than his current employment, he would choose not to move, even though he is a more productive worker in the city than the country. But it is efficient that he not move, if "income" is defined widely enough to include the emotional and monetary cost of relocation.[5]

How should we treat attachment to place in equity terms? Suppose Maggie and Paul and Sadie do the same job, but Maggie and Paul live and work in the city and Sadie lives and works in the country. Begin in equilibrium, so that they each earn the same annual income. Now suppose two events: the rural economy falters, such that Sadie's income falls, and Paul loses a major customer, so that he also suffers a fall in income, of the same magnitude as Sadie's. Sadie could continue to earn the same income as before, but only if she moved to the city to work in Maggie's company. Suppose there is a progressive income tax in place, so that if nobody moves Maggie's tax bill will rise relative to Sadie's and Paul's. Is it equitable to have an additional transfer program in place that would tax the city residents Maggie and Paul in order to subsidize Sadie's employment so that her income doesn't fall? In other words, does Sadie have a special claim on the basis of where she lives, greater than any claim Paul might have?

Traditional economic analysis would say that Sadie doesn't have a special claim – income redistribution should be on the basis of income, dependents, and special needs such as specialized health care, but not to subsidize a preference for living in a particular location. Even when we turn to analysts who have tried to go beyond mere income to

[5] Bolton (1992) attempts to incorporate the value of a sense of place into economic policy analysis, but still concludes that it is only on the basis of market failure that we would find a rationale for policy intervention to stem the flow of migration.

estimate the standard of living we find that a desire not to move doesn’t enter the calculus. For example, the United Nations Human Development Report (1996) in its “balance sheet of human development” considers, in addition to income and employment, health, education, the status of women, social security (in terms of an income safety net), social fabric (considering such aspects as access to information, crime rates) and environment, but has no mention of the ability to remain in place regardless of economic change. The UN’s estimate of the “capability poverty measure”, based on the work of Amartya Sen (1987; 1993), considers three basic capabilities: to be well nourished and healthy, to have the opportunity for healthy reproduction, and to be educated and knowledgeable. Again, “sense of place”, and the ability to maintain a constant income without ever having to migrate, do not appear. In an extensive critique of the standard methods of economic cost-benefit analysis, Martha Nussbaum (2000: 1021-2) provides a much longer list of what she considers to be the central human capabilities, including various equality rights, political rights and freedoms, rights of association and, interestingly, the freedom *to* move. But the freedom to remain in place regardless of the patterns of economic change does not appear.

The UN and Sen and Nussbaum could hardly be considered narrow minded in their conceptions of what constitutes economic justice. Still, there is a consistent theme in their broadening of the scope of what should be included in measures of the standard of living, and that is that they do *not* include as a factor the preferences, or tastes, of individuals. If sense of place is to have a role in the equity side of policy analysis, it would have to be through this route, that a person living in a rural area places a value on staying there that needs to be taken into account.

Obviously it is difficult to include preferences in the development of redistribution policies. We generally hold that a poor person with champagne tastes is not entitled to a greater transfer through the state than other poor people. One reason is practical: if transfers were based on tastes, people would lie about their tastes – everyone would claim a daily need for expensive items. The other reason is ethical: for the most part we don't feel people with champagne tastes deserve more.

That we shouldn't compensate individuals on the basis of their preferences is one of the central results of the modern liberal theory of John Rawls (1971) and Ronald Dworkin (1981), who begin with the fundamental liberal principle that government should not discriminate between different conceptions of the good life. They are egalitarian, but it takes the form of ensuring that the welfare state provides all individuals with those "primary goods" that anybody would want regardless of their life plans. Primary goods include "rights and liberties, opportunities and powers, income and wealth" (Rawls, 1971: 92), but would not allow for special consideration beyond that.[6]

But perhaps *place* is not a commodity like all the others. Margaret Jane Radin (1986) assesses the standard economic line against residential rent control. If where we live were simply another good, like a television set or a carpet cleaner, then we could easily make the case that price controls are a bad idea. But television sets and carpet cleaners are obviously just commodities; if we lose one we can always be compensated

[6] See Hausman and McPherson (1996: chapter 10) for general discussion. Arneson (1990) provides a critique, claiming that if we are willing to provide special assistance to those with physical handicaps (as Rawls and Dworkin argue we should) then we cannot escape compensating individuals for having different tastes. See also Levine (1995) and Van Parijs (1991) who analyse the liberal position with respect to individuals who strongly prefer not to work.

with a new one or the cash equivalent. But if location becomes a part of what we are as people, then losing a residence one has rented for a long time, say because of an unaffordable increase in rent, is not easily replaced. Radin's argument, although dealing with urban housing policy, is important in our context because it could be invoked as an argument for rural subsidy – sense of place matters in the determination of equitable policies in a different way than cash income.

There are two large practical flaws in Radin's case. First, sense of place is a preference felt differently by different individuals, and cannot be accurately observed. How could we operationalize attachment to rural living as a criterion for subsidy? It is particularly difficult when for some individuals there will be a negative sense of place – the youth who has been raised in the small town who would strongly prefer living in the city. For subsidizing rural areas means reducing the opportunities in urban areas, and so we benefit one group at the expense of another on the rather arbitrary basis that those who like where they live are privileged over those who do not.

The second flaw is that Radin does not address the creation of the wealth, in her example rental housing stock, that she wants to redistribute. As stated earlier, a growing economy requires flexibility in the allocation of resources and in the prices they command. We cannot take the existing stock of wealth and treat it as if it were simply a gift of nature that can now be redistributed on some just and fair basis.[7]

So it is difficult to justify accounting for the preferences of individuals in redistributive policies, even if we think attachment to a place might be important. There

[7] See Schmidtz (1998) for a powerful critique of those who would entirely separate questions of distribution from how what is being redistributed has come into being.

is one last aspect to consider, not found in the academic literature, but that can sometimes appear in popular debates. This is the notion that sense of place in general might not be something appropriate to consider in redistributive policies, but *rural* sense of place is a different case. In popular literature and art there is a strong expression of the idea of nostalgia for rural life, equated with hard work and a stronger sense of morals. It arises from a number of sources, including the frustration many feel from the pressures of modern life, but has a long tradition.[8] Here I will direct my attention to one particularly troubling manifestation of this idea, because it relates directly to the question of economic policy. In the most recent Saskatchewan budget (2001), in its introduction to the discussion of rural revitalization, we are told: "Rural Saskatchewan is an excellent place to live and raise a family. It affords a quality of life second to none, with a clean environment and safe communities. … Rural residents have the strength, energy and creativity to seize and build upon new economic opportunities" (p. 29). What judgment is being made in this budget document? Should it be the basis of how public infrastructure is allocated across the province?

Conclusion

Rural Canada: Moving Forward or Left Behind? The question is wrong. It is the welfare of *Canadians* that matters, not the level of economic activity in a particular *place*. When we analyze policies affecting the welfare of Canadians, we do so by looking at whether

[8] See Hofstadter (1963: 272-82) on the anti-intellectual tradition among American farmers, dating back to the founding of the republic.

policies are increasing the total wealth of the nation, and at how the total is distributed, with particular attention to those at the bottom of the income scale.

When policies are directed at trying to increase economic activity in one place at the expense of another, such as efforts to "revitalize" the rural economy, we lower the total wealth of the nation, and adopt what is an ineffective way to increase the economic opportunities of the worst off. In no way should all this be taken to mean that we should take active government measures to *hasten* rural-urban migration. What it does mean is that so far as possible government current spending, investment, and taxation should be neutral across regions and industry, providing public infrastructure where its economic value is highest, and redistributing income on the basis of individual circumstances, not on whether a family lives on a farm or in a small town.

People currently living in rural areas are only as rich as they are *because of* past out-migration. Our income per person would be tremendously lower if we had the same distribution of population now as sixty years ago. The high standard of living Canadians enjoy is the result of living in a dynamic, not static, economy. We cannot simultaneously say that we want to maintain strong economic growth *and* keep our rural areas looking just the way they always have. Romanticized notions of the goodness of rural life are no escape from the real world of economic growth, and should have no place in government budgetary policy.

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