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The Politics of Poverty and the Poverty of Politics

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How much should government do to help the poor directly through taxes and transfers designed to reduce income inequality, instead of indirectly by confining itself to the limited, but important, tasks necessary for the private production of wealth through specialization and market exchange? In "Capitalism and Freedom," Friedman argues—very little. He comes close to arguing that the state should not concern itself at all with reducing income inequality, though he does leave the door slightly open on the grounds that state redistribution can serve as insurance (162-63). And he makes a positive case for some state action to alleviate poverty using the argument that such alleviation is a public good, or in his words, creates a "neighborhood effect" that private charity doesn't fully consider (191).

Two considerations are relevant to any case for direct government transfers from the non-poor to the poor: 1) the actual degree of inequality, and 2) the effectiveness of government transfers at reducing inequality in ways that reduce poverty. As expected, Friedman doubts that inequality is a serious problem, or that direct action by government has done much to reduce inequality and poverty. With respect to 1), Friedman states that a "[s]triking fact, contrary to public conception, is that capitalism leads to less inequality than alternative systems of organization and that the development of capitalism has greatly lessened the extent of inequality" (169), and his discussion of progressive income taxes, public housing, wage and price supports, and Social Security points out how ineffective they have been at helping the poor (172-89). Far more effective would be eliminating many existing government restrictions, such as trade restrictions and grants of monopoly privileges, which hamper the productivity of the marketplace (176). Friedman does, however, argue for a negative income tax as an effective government policy for alleviating poverty by directly transferring income to the poor (191-92).

Our purpose is to reinforce Friedman's arguments by first, considering in more detail than he did, why there is much less income inequality and poverty than commonly believed, and second, arguing that government transfer programs have not only failed to reduce income inequality and poverty, but are incapable of doing so because of limitations inherent in the political process.

Exaggerating Inequality and Poverty

The motivation to exaggerate the level of income inequality and poverty is strong, and it is not confined to the poor. In fact, any motivation the poor have to exaggerate their plight is, for reasons we shall discuss in Section III, of little consequence. Organized groups whose members are not poor benefit from government programs which, quite apart from their effect on the income distribution, are justified in the name of helping the poor. Doctors have benefited from programs to provide medical care to the poor, farmers have benefited from programs to provide food to the poor, the construction industry has benefited from programs to provide housing to the poor; unionized workers have benefited from minimum-wage legislation, and educators have benefited from programs to increase educational opportunities to the poor, not to mention government workers who have benefited from administering these programs and the politicians who realize electoral advantage from enacting them. Since so many with political influence gain by attacking poverty, it is not surprising that the problem has, like Mark Twain's premature death, been greatly exaggerated.

As we began considering all the ways that poverty and income inequality have been exaggerated, it was hard to know where to begin.

So we started with one of the most obvious features of income statistics that exaggerate the actual amount of income inequality.

A Snapshot Versus a Life Cycle

The income distribution statistics that are routinely reported show how much income different groups have at a particular time. This information would be of interest if everyone's income remained the same throughout their lives. But in the real world, a snapshot of income figures is meaningless as a measure of poverty. For example, many people, probably most of us, have chosen to earn small incomes early in our lives to acquire the experience and education necessary to earn larger incomes later. Most people are far more interested in their lifetime incomes than in their incomes at any particular time, and the distribution of lifetime incomes is more equal than the distribution of incomes at any one moment. For example, even if everyone had exactly the same lifetime income, the income data reported at any given time would show significant income inequality. On the other hand, if everyone had the same income at each moment, then lifetime incomes would also be equal. Obviously, lifetime incomes are not equal, but they are more equal than suggested by the income inequality reports we constantly hear reported.

It is difficult to know exactly how much more equal lifetime incomes are than current incomes, since there is no data on the inequality of lifetime incomes. But the more variability in people's income over their lifetimes, the more equal lifetime incomes can be expected to be relative to current incomes. For a review of studies that have been done on income mobility see Atkinson, Bourguignon, and Morrisson (1992).

Reliance on Household Data

The most widely cited data on U.S. income inequality are reported by the U.S. Bureau of the Census and give the percentage of total income going to five household groups (quintiles). The data shows what percentage of total income is received by the top 20 percent of households, right on down to the percentage earned by the bottom 20 percent of households. According to the 2002 Census report, the top 20 percent of households received close to half of the total income and the bottom 20 percent received only about 3.5 percent. This income inequality is always presented as a shameful commentary on the fairness of American society, and invariably calls for sad faces when reported by TV news anchors. And when, as is sometimes the case, the bottom fifth of households are receiving a smaller percentage than they did according to the previous report, we are sure to hear that the poor are getting poorer and the rich are getting richer.

Fortunately for the poor, and for the fairness of America, the Census reports tell us very little about the financial well-being of those in the bottom income quintile, and they certainly provide no evidence that the poor are getting poorer. Indeed, the bottom 20 percent of households are becoming wealthier, which could be one reason the Census reports show that the percentage of income going to them is declining, as we shall explain momentarily.

The biggest problem with data on household incomes is that they are based on household data rather than on individual data. This would not be a problem if all households contained the same number of people, but they don't. Households in the highest quintile of household income contain significantly more people than those in the bottom quintile. By considering income in each quintile without adjusting for the number of people receiving that income, the Census Bureau approach could be used to conclude that the people in Sudan are richer than those in Beverly Hills. Also, the Census Bureau report doesn't include all the income received by the poorer households (for example, the value of such in-kind transfers as food, housing, and medical care are not included), and it also fails to consider the differences in taxes paid by higher- and lower-income households. Only by including in the Census Bureau reports all the income received, the taxes paid, and differences in the number of people in different household groups can we get even a reasonable snapshot measure of income inequality. This is what Rector and Hederman (2004), did with the 2002 Census Bureau report.

According to the 2002 Census Bureau report, the top quintile household received 49.6 percent of total income, and the bottom quintile received only 3.45 percent. In other words, the richest 20 percent of households received $14.37 for every $1 received by the poorest 20 percent. But things start looking different when one considers non-cash income received and differences in taxes paid. Once this is done the percentage income (after-tax income) drops to 46.16 percent for the highest quintile and increases to 5.35 percent for the lowest quintile. But the biggest change occurs from recognizing that top-quintile families are significantly larger than bottom-quintile families 24.6 percent of the population is in the top quintile and only 14.3 percent is in the bottom quintile. Comparing incomes in the different quintiles on a per-capita basis, one finds that the highest quintile of people (not households) receives 39.64 percent of income (again, after-tax income) and the lowest quintile of people receives 9.4 percent. This means that those in the top percentile received $4.21 (not $14.37) for every $1 received by those in the lowest quintile. Our news anchors could present this more accurate measure of income inequality almost with the cheerfulness of a San Diego weatherman, particularly when we also recognize that much of the reduced inequality that remains is explained by the fact that households in the highest income quintile contained almost 2.5 times as many working-age adults as households in the lowest quintile, and that working-adults in the highest quintile worked about twice as many hours per year on average as the working adults in the lowest quintile.

The poor are often shown as getting poorer by the Census Bureau reports because they are actually getting richer. For example, in 1973 the bottom quintile of households received 4.2 percent of income, as measured by the Census Bureau, which dropped to 3.45 percent in 2002. Because those who at any particular time are considered poor have become better off over time, more of the poorer young adults have been able to move out of their parents' homes and into their own apartments, thus creating more households containing only one person. Similarly, more relatively poor widows and widowers have become wealthy enough to maintain their own homes rather than move in with their children, again increasing the number of one-person households. Of course, this reduces the people in, and the amount of income going to, the lowest-income households, which show up as a decline in the income of the lowest quintile. True, the bottom quintile of households could show a fall in the percentage of income they receive because poor individuals really are becoming poorer. But as we now explain, all income groups in America have become better off, so increasing poverty cannot be the explanation for the increased inequality that the Census Bureau numbers purport to show.

The Poor Are Getting Richer

We are constantly bombarded with the claim that lower-, and even middle-, income workers are earning less now than they were in the 1970s. Sure, the argument goes, their incomes are higher when measured in current dollars, but not after we adjust for inflation to compare the purchasing power of their incomes today with their past incomes. According to figures used to support this view, from 1973 through 1996, average hourly wages in America declined in real terms by 15 percent. Things improved slightly in the last few years of the 1990s, but then deteriorated during the first few years of the 21st Century, supposedly leaving workers about as far behind as ever.[1] This is a serious problem, if true. Fortunately, it's not true. The most obvious

[1]These figures are cited in Cox and Alm (1999, 4)as preliminary to their argument that such figures are misleading and that the poor have become better off since the 1970s. Our argument draws on theirs in important ways.

evidence comes from looking at what the poor are consuming now, versus what the average American was consuming in the early 1970s.

Consider some things, that few, if any, average Americans had in the early 1970s, but which the poor commonly had in 2001. In 1971, 43 percent of Americans had a color television, 97 percent of poor families had at least one color television in 2001; in 1971, no American had cable or satellite reception, 62 percent of poor families had it in 2001; in 1971, 32 percent of American families had air conditioning in their home, 76 percent of poor families had it in 2001; in 1971, less than 1 percent of American families had a microwave, 73 percent of poor families had one in 2001; in 1971, no American had a VCR or DVD, 78 percent of poor families had one or other in 2001; in 1971, no American had a cell phone, 25 percent of the poor had one in 2001 (Cox and Alm, 1999; and Rector and Johnson, 2004). And, numerous medical procedures and medications unavailable at any price not that long ago are now routinely available to the poor.

These examples, and others that could be given, of what the poor have today compared to what the average American had in the early 1970s, are impossible to reconcile with the claim that the real wage of the average American has declined since the early 1970s. Understanding why this claim is wrong requires a quick comment on why the Consumer Price Index (CPI) overstates the amount of inflation, and therefore understates the value of current dollars relative to past dollars (say 1973 dollars). The CPI compares the dollar price of a representative bundle of goods today with the dollar price of the same bundle in some base period. For example, if a bundle of goods that costs $1,000 in 1990 costs $1,400 in 2005, then the CPI for 2005 is 40 percent higher than in 1990; if the CPI was 100 in 1990, it is 140 in 2005. In this example, if a worker's wage in current dollars has increased by less than 40 percent since 1990, then he would officially be considered poorer today than he was then.

The problem is that the CPI has been overstating inflation, and thus overstating the reduction in the value of current wages. There are a number of reasons for this, including the inability to properly adjust for quality improvement in existing goods (for example, a car today is more reliable, safer, and more comfortable and requires less maintenance than the same make and model 15 years ago), and to properly adjust for the availability of completely new goods. The introduction of new goods, for example, requires that the composition of the representative bundle of goods be occasionally changed to include those goods. When a new good becomes available, it will not be put in the representative bundle immediately since it is commonly very expensive and sold to very few people, typically the wealthy think about the home computer when it was first introduced. Only after its price has come down to the point where it is in wide use will it be included in the representative bundle. This means, of course, that the dramatic price declines for many new goods are not reflected in the CPI.

A 1996 presidential commission, headed by Stanford University economist Michael Boskin, concluded that the CPI had been overstating inflation by as much as 1.1 percentage points a year.[2] Since then some adjustments have been made to the index, but because of political resistance to reducing the growth in the CPI, most economists believe that it continues to overstate inflation.

The upward bias in the CPI explains why studies can show that the real income of poor workers has declined since 1973, indicating that they are poorer now than then while they can now purchase far more and better goods than they could before. The best way to determine if the poor are better off is to look at what they can buy. Based on that criterion, most of the poor today would be considered quite well off by the poor of a few years ago.

[2]The official citation of the commission's report is the Advisory Commission to Study the Consumer Price Index, U.S. Senate Finance Committee, "Toward a More Accurate Measure of the Cost of Living" (December 4, 1996).

Outcome vs. Process

Independent of the accuracy of figures on income inequality is the question of how to judge whether one level of inequality is better than another. Most discussions of data on income inequality simply assume that less inequality is better than more. But income inequality is the outcome of some process, and it makes little sense to judge the desirability of a particular level of income inequality without considering the desirability of the process that brought it about.

For starters, it would be impossible ever to reach an agreement on the desirability of any particular of income inequality. In this regard, a major advantage of emphasizing processes rather than outcomes is that we can reach broad agreement on processes, while attempting to reach such an agreement on particular outcomes would be not only impossible, but socially divisive. As Hayek (1976, 3) stated, "What makes agreement and peace in … a society possible is that the individuals are not required to agree on ends but only on means which are capable of serving a great variety of purposes and which each hopes will assist him in the pursuit of his own purposes."

However, assume that somehow we could all agree on the ideal amount of income inequality, and then achieve it.[3] Of course, maintaining a given amount of income inequality (ideal or not) would be effectively impossible. So the question is, would the inevitable move away from the agreed upon ideal amount of income inequality be considered less than ideal? It depends on the process that brought about the change. Consider two polar cases. If income inequality decreased because of an epidemic of armed robberies by the poor, most people (possibly excluding the robbers) would view the lower level of inequality unfavorably because of the process by which it came about.

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[3] Achieving a particular level of income inequality, even if everyone agreed on its desirability, would either be impossible or require so much authoritarian control over individual actions that the incomes of everyone, except possibly the authoritarians, would be drastically reduces.

On the other hand, if the income inequality increased because a medical researcher became rich by developing a medication that saved millions of lives, most people would view the higher level of inequality favorably because of the process that caused it.

We assume here that people make the connection between the change in income inequality and the process generating it. If they do not make the connection, or don't understand the process, it is likely that many people will object, say, to an increase in inequality that leaves everyone better off, because they fail to understand the benefits of the underlying process. The failure to understand the positive-sum nature of the market process, for example, goes a long way in explaining why many people criticize income inequality that increases the well-being of all. For example, much of the inequality in income and wealth[4] results from saving and investing decisions people make. Even if everyone had the same income profile during their lifetimes, some would end up far wealthier than others because of rather small differences in their savings rates. For example, the median-income family that saves 10 percent of its income over the career of the wage earner(s) and invests it in an indexed mutual fund can easily accumulate well over a million dollars by retirement. This family's wealth will reflect the fact that its savings and investing have increased the productivity of the economy and wealth of others.[5] Another family that saves nothing out of the same

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[4]Given an appropriate discount rate, any income stream can be converted into a given amount of wealth, and vice versa. But measures of income equality consider only current income. A more inclusive measure of financial inequality would consider the equivalence of income streams and wealth, but constructing such a measure would require more information on future earning and interest rates than can be accurately obtained.

[5]See Lee and McKenzie (1999) for a detailed discussion of now become a millionaire in today's purchasing power is possible for almost anyone born in America.

income (not counting the difference in wealth accumulation as income) can find itself approaching retirement with no wealth at all except for Social Security. Of course, not all wealth differences between families are the result of differences in their productivity, but most of them are.[6] When figures on income and wealth inequality are reported, the report almost never mentions that the process that generated the inequality serves the interest of those at every position on the income ladder.

Even if it becomes widely recognized that income inequality is not as large, or as unjustified, as most people have been led to believe, many will remain convinced that measures are still warranted to reduce it. But what measures? The reflexive answer is government programs that transfer income/wealth from the wealthy to the poor through differential taxes and direct transfers. We now consider how effective government measures have been, and can be, at reducing income inequality.

Can Taxes and Transfers Help the Poor and Reduce Income Inequality?

At first glance it seems obvious that increasing taxes on the wealthy and using the tax dollars to make transfers to the poor reduces income inequality. Indeed, we have argued in Section II that considering the differences in taxes paid by the rich and the poor, and including the in-kind transfers going to the poor, reduces the income inequality reported by the Census Bureau. But we have to be careful here. Of course, the poor will be seen as better off when the benefits they receive from existing policies are counted than when those benefits are not counted. However, the question is, are the poor better off relative to the non-poor because of existing government taxation and transfer policies,

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[6]Stanley and Danko (1996, 16) find that over half the millionaires in America never received any inheritance, and less than 20 percent inherited 10 percent or more of their wealth.

than they would have been if government had done nothing to favor one income group over another, allowing the income distribution to be determined by the competition of the marketplace? We believe the answer to this question is no. Furthermore, we now argue that, given the realities of the political process, government may be incapable of helping the poor relative to the non-poor.

Political Competition

If government tax and transfer policies were motivated solely by the desire to transfer income from the rich to the poor, there is little doubt that this could be accomplished. But the desire to help the poor is only one of many concerns motivating government taxes and transfers. Clearly, some policies do transfer income to the poor, and if one looks at those policies in isolation from the overall effect of the political process, it is easy to conclude that the poor benefit from government transfers. This is a distorted view since the transfers to the poor depend on a political process that transfers wealth to a host of non-poor groups as well.

The belief that the government has a unified purpose (determined by majority vote) and the ability to pursue it effectively is a common and comforting one. Since a majority of the voters surely favor at least modest government transfers to help the truly poor escape poverty, many believe that this is what government is either doing, or making a serious effort to do. A more realistic view is that political outcomes are determined by competition for government favors between many different groups, with that competition favoring those most successful at exerting political influence. The poor have some influence in this political competition, but they are not among the most influential. The poor, certainly the persistently poor, are poor because they lack the connections, skills, and attitudes necessary to succeed in market competition. When considering how effectively government can help the poor, people ignore the question; can we expect those who have failed in market competition to succeed in political competition?

The only reasonable answer is, not very well.

As the constraints on permissible government action have weakened since the 1930s, increasing numbers of interest groups have found it profitable to devote more effort to rent-seeking for political transfers, privileges, and protections—capturing existing wealth—and less effort to producing new wealth. Success at this rent-seeking depends on a group's ability to exert political influence as a member of a majority coalition critical to the fortunes of politicians and their parties. As observed by Hayek (1979, 99), "If [the government's] powers are not limited, it simply cannot confine itself to serving the agreed views of the majority of the electorate. It will be forced to bring together and keep together a majority by satisfying the demands of a multitude of special interests, each of which will consent to the special benefits granted to other groups only at the price of their own special interest being equally considered." Those groups most influential in such coalitions are relatively small, are already well organized (typically around a corporate or occupational interest), provide campaign contributions and a significant number of jobs to well-placed politicians and their political jurisdictions, and have an intense interest in particular pieces of legislation that concentrate benefits on their members. These characteristics do not describe the poor. They do, however, describe corporations and industries which employ people who are hardly poor, and often quite wealthy.

It should not be surprising then that the term "corporate welfare" describes a significant portion of government transfers. A recent study by Slivinski (2001) estimated that the federal government spent $87 billion on corporate welfare during the 2001 fiscal year, where such welfare is defined narrowly to include only direct expenditures to finance "subsidies, grants, funding for specific applied research that helps bring profitable products to market, and other special privileges that benefit targeted firms and industries" (Slivinski, 6). For example, the U.S. Department of Agriculture spent $35.79 billion, or 51 percent of its budget, on corporate welfare in fiscal year 2001, with $14.57

billion going to support agricultural prices, and $2.58 billion spent to subsidize crop insurance. The Department of Transportation spent $10.39 billion, or 21 percent of its budget, on corporate welfare in fiscal year 2001, with $554 million going to subsidize Amtrak.

Furthermore, Slivinski's $87 billion estimate for corporate welfare significantly understates the total social cost, since it includes only direct payments from the government. His estimate does not consider the benefits businesses favored by government receive from special tax preferences or import restrictions. For example, producers of ethanol and other alternative fuels received $940 million in special tax credits, with the large and profitable agribusiness, Archer Daniels Midland, receiving a major share of those credits.[7] The U.S. International Trade Commission estimated in 1999, that just the most significant trade barriers protecting U.S. businesses against competition cost the U.S. economy about $12.4 billion Slivinski, (25). For example, it was estimated in 2000 that restrictions on importing sugar cost the American consumer about $2 billion a year (Slivinski, 25).

Certainly a large amount of money is transferred through government programs that cannot be described as going to corporate welfare and is widely seen as benefiting the poor. But much of this money goes to people who are not poor, with political influence rather than poverty being the critical determinant of the distribution of these transfers. In 2000, the federal government transferred $1.07 trillion, but only $312 billion (about 29 percent) was means-tested earmarked to the poor (Rector, 2001, 2). The other 71 percent about $758 billion in 2000 was distributed with little attention to need. For example, in 2003, Social Security payments of $406 billion were made to the elderly regardless of their wealth. Elderly families have roughly twice the net worth, on

[7]This example comes from an appendix to Slivinski (2001, 25). Given the large number of special tax preferences in the tax code, it is difficult to come up with an aggregate figure for the size of these transfers to businesses.

average, of non-elderly families. Over $280 billion in annual Medicare payments goes almost exclusively to the non-poor, since the poor receive medical assistance through Medicaid, a smaller program.

Not only do the poor receive a smaller percentage of government transfers than the non-poor, and certainly less than most people realize, but a larger share of their transfers is worth less to them, per dollar transferred, than the transfers received by the non-poor. This is explained by the fact that the poor receive a smaller proportion of their transfers in cash than do the rich. Slightly over half of all the transfers targeted to the poor are in the form of medical care. In addition to medical care, the poor receive a significant proportion of their assistance for such things as housing, energy, and job training transfers that provide benefits to the politically influential groups supplying them. This means that well over half of the transfers going to the poor are in-kind transfers. On the other hand, transfers that are not means-tested are more likely to be in the form of cash. In 2000, for example, Social Security retirement payments were $353 billion, which came to over 46 percent of non-means-tested government transfers during that year. Many other non-means-tested transfers are also in the form of cash payments, with the transfers to non-poor farmers alone pushing cash payments to the non-poor to over 50 percent of the total transfers received.

In-kind transfers are certainly worth having. However, the poor, like the rest of us, value cash more than in-kind transfers because cash allows them to choose what they value most, not what others think they should have. So, of the transfer dollars going to the non-poor, a higher percentage are worth a dollar to the recipients than is the case with the transfer dollars going to the poor. Once we consider all government transfers, and not just those to the poor, it is clear that the poor are being out-competed for government largess. In the next two subsections we consider private responses to transfers and taxes that also neutralize their effectiveness at helping the poor.

Transferred Income vs. Earned Income

Attempts to determine how impoverished the poor would be without government transfers typically subtract the income transferred from the total income received and assume that what remains is how much the recipients would have without government help. In other words, the entire transfer is assumed to represent the benefit received. Not surprisingly, these studies conclude that government programs significantly reduce the poverty rate. Indeed, using this approach, one could conclude that without government transfers large numbers of people would be starving in the streets.

The critical flaw in such studies is in failing to consider the negative effect of transfer programs on how much income is earned by the beneficiaries of the transfers. They implicitly assume that people will earn the same amount whether or not they receive transfers. This is seldom, if ever, true. For example, when transfers are means-tested, a penalty is imposed on those who earn above some limited amount of income as they begin losing their transferred income. This penalty is commonly quite large, especially when people are receiving assistance from several programs, each one of which reduces benefits as earned income increases. The effect of this penalty on the poor is the same as an income tax with a high marginal rate, which reduces the incentive for them to work their way out of poverty. The transfer programs thought to be helping people escape poverty are often trapping the most vulnerable poor into perpetual poverty, as they substitute pitiful welfare payments and the squalor of public housing for the responsibility and skills needed to earn a higher standard of living and a sense of dignity. The failure of welfare to improve the incomes of welfare recipients, and the quality of their lives, was an important motivation for the welfare reform of 1996, The Personal Responsibility and Work Opportunity Reconciliation Act of (1996), which limits the time one can remain on welfare.

A Smaller Pie

To be fair, only a small percentage of welfare recipients were trapped into long-term dependency before the welfare reform of 1996, although it was tragic for those who were. Most poverty is episodic; affecting an average of 21.4 percent of the population, with only 5.3 percent of the population remained in poverty over a two year period according to a recent study (U.S. Census Bureau, 1998). There is no reason to believe that the long-run effect of government transfer programs, taken in total, has been to alter the distribution of income in favor of the poor. If, as we discussed earlier, the poor are no better at competing in the political arena than in the market, then increasing the amount of wealth allocated politically by reducing the amount allocated through the market should have no effect on the distribution of income. This seems to be true, suggesting that the enormous growth in government transfers since the 1960s not only has failed to help the poor, but almost surely has harmed them.

Federal transfers to individuals (not counting payments for goods and services provided or interest for money lent) was 27 percent of federal spending in 1962 (Stein and Foss, 1995, 212). Federal transfers had increased to approximately 62 percent of a much larger federal budget by 2000 (Budget Of the United States Government, 2002). Despite this significant increase, there is no evidence that there has been any noticeable change in distribution of income (after taxes and transfers)—the percentage of income going to the poor, the rich, and all the income groups in between, has remained remarkably constant. In one of the earlier studies on the change in U.S. income distribution over time (Reynolds and Smolensky, 1977, 1978) concluded that there was effectively no change between 1950 and 1970, a period that covered the early years of the "war on poverty" and the corresponding increase in federal transfers. Since the end of their study, and a further expansion in federal transfers (both absolutely and as percentage of government spending), the studies of the Census Bureau using household data shows that the percentage of income going to the bottom 20 percent has declined sharply 6.7 percent in 1970 vs. 3.45

percent in 2002 and the percentage going to the top 20 percent has increased sharply 39.9 percent in 1970 vs. 49.6 percent in 2002. As explained in Section II, however, these differences between 1970 and 2002 may be explained largely, if not entirely, by the decline in the number of people in the bottom 20 percent of households, both absolutely and relative to the number in the top 20 percent of households, and the omission of taxes and in-kind benefits in the Census studies.

The most thorough study since that of Reynolds and Smolensky on the effect of taxes and transfers on income distribution was done by Pechman (1985). His study focused primarily on the effect of taxes on income distribution, and found little effect. He did find some equalizing effect on the income distribution from transfers, like Social Security payments and Medicaid and Medicare transfers, but the study did not consider in detail the effect of the entire range of transfers and trade restrictions that are best classified as corporate welfare, and discussed earlier in this section. According to a recent *New York Times* article by Altman (2002, BU 4), the Pechman study "showed that the entire tax and transfer system, including personal and corporate taxes and government subsidies and entitlements, had virtually no effect on the distribution of income in the United States."

Of course one can always question empirical studies of something as hard to measure as the distribution of income. But one cannot doubt that the taxes and government transfers do a lot less to alter the distribution of income toward the poor than the political rhetoric used to justify those taxes and transfers would have us believe. Likewise, while measuring precisely the effect of taxes and transfers on economic productivity and growth is impossible, those effects are clearly negative. There will always be debate about the magnitude of the disincentives created by government transfers, but no serious economist doubts they exist. Even Arthur Okun, President Johnson's Chief Economist, and an advocate of government transfers to the poor, compared transfer programs to a "leaky bucket" to illustrate the inevitable disincentives built into transfers that always increase recipient income by less than the cost of the transfer. Okun's bucket leaks from both the bottom and the top. We have already seen that the transfers reduce recipients' incentives to acquire the skills and take the initiative to be productive, so they substitute publicly-provided income for privately-earned income. And the higher taxes needed to finance transfers to the poor also reduce the incentives for high-income taxpayers to work as hard, earn as much, and make risky investments, which reduces the income available for transfers, and also diminishes the economic activity and job opportunities that make it easier for the poor to improve their own conditions.

In other words, the transfers that are supposed to help the poor reduce the size of the economic pie below what it would have otherwise been. So even if the net effect of all government transfers, those going to the wealthy as well as to the poor, shifts the distribution of income in the direction of the poor, those transfers could still be reducing the income going to the poor. A bigger piece of a smaller pie can be a smaller piece of pie.

Conclusion

We make two arguments in this paper. First, the data on income distribution systematically overstate the inequality in incomes, leaving the impression that the poor are worse off, both absolutely and relative to other income groups, than they actually are. Indeed, it may be that the official income distribution data shows that the poor are becoming worse off when, in fact, they are becoming better off. Second, government has not done much, if anything, to reduce poverty by transferring income from the wealthy to the poor. Furthermore, government seems to be incapable of altering the distribution of income in favor of the poor.

Our arguments point to an interesting dilemma for those who see more government spending as necessary to reduce poverty. To justify the additional government spending, anti-poverty activists need to convince the public that poverty remains a serious (indeed, a worsening) problem. But if government spending is the key to reducing poverty, why is it that after billions of dollars have been spent on government anti-poverty programs, poverty is worse than before? The response to this dilemma is that 1) without government spending the poverty problem would have been even worse, and 2) large numbers of poor people are being helped by particular programs and they would be clearly harmed if those programs were scaled back, or eliminated. This two-pronged response is politically effective since it takes advantage of the "what is seen and what is not seen" problem discussed by the nineteenth-century French economist, Bastiat (1995). It is much easier to see how particular poor people benefit from government spending than to see the widely dispersed and delayed cost of that spending in terms of more unproductive political competition for government transfers that the poor seldom win, and the diminished economic productivity that disadvantages everyone, particularly the poor. And even if people do become aware of these costs, they are unlikely to trace the cause back to the government transfer programs responsible. Our purpose has been to sharpen the focus on "what is not seen" by arguing that government transfers have not only done little, if anything, to reduce income inequality, but have surely harmed the poor whom they are supposed to help. Furthermore, this failure cannot be remedied by electing better politicians, or hiring more informed bureaucrats, but is the inevitable result of perversities built into the political process.

Our arguments lead us to a mixed conclusion regarding Friedman's (1962) discussion of government programs to help the poor. Although we are not completely convinced that markets reduce income inequality below that resulting from political action, we do not believe markets lead to more income inequality. On the other hand, we are less sanguine than Friedman about government's ability to help the poor with direct transfers. For example, we doubt that his negative income tax proposal would ever be enacted without being part of a broader political package containing even larger transfers to the non-poor.

Friedman is surely correct when he argues that there are neighborhood effects (or positive externalities) associated with helping the poor. But this would justify government transfers to help the poor only if they actually helped the poor. Unfortunately, government transfers are themselves plagued with a host of negative externalities (many, though not all, explained by the ability of organized groups to secure private benefits at public expense), rendering them a highly unlikely way of helping the poor.

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