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Income Inequality and Poverty: Are We Asking the Right Questions?

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It is frequently taken for granted that income inequality is a problem in the US. This paper examines the data and confirms that income inequality does indeed exist in the US – and has been rising in the past 40 years. There are, however, two problems. First, the rise in income inequality masks a significant improvement in the lot of the poorest Americans. Second, government efforts to reduce inequality – much like government efforts to reduce poverty – are likely to have unintended consequences that hurt the poorest. The paper concludes with international data and general analysis. Too much poverty persists and income inequality can have some negative consequences; however, government efforts should not target inequality, but should instead focus on reducing barriers to earning.

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Introduction

Income inequality has galvanized many Americans, including economists and public intellectuals. The issue is inevitably more complex than a news soundbite. First, we need to ascertain the breadth and depth of income equality. Second, in the classical liberal tradition, we must recognize that any policy addressing inequality will inevitably trigger a cascade of the ubiquitous unintended consequences accompanying any government action. In short, it is prudent to tread cautiously in adopting policies, lest the unintended consequences overwhelm the intended ones.

We will argue in this paper that income inequality has indeed been rising in the US over the past 40 years, but (a) it is not the problem that many say it is; and (b) efforts to reduce income inequality will likely end up hurting the poorest Americans. There is too much poverty in the US (if only in the sense that it is largely avoidable, if only the economy were allowed fully to lift up the poorest) – but income inequality is the wrong problem, and most policies to reduce it will ultimately be detrimental, especially to the poorest.

We address the problem of income disparity in four sections. Section one discusses income disparity trends in the US over the past 40 years. Section two examines the economic importance of these trends. Section three examines the costs of addressing income inequality. The final section concludes.

Income Inequality in the US

Prior to any policy discussion on income inequality, we need to assess its current status.[1] We begin by examining income statistics in the U.S. from 1970 to 2007. This 37-year period is sufficiently long to be representative. But we intentionally end the table's data in 2007, because of the distortionary effects of the housing bubble, recession, recovery, and bailout.[2]

SHARE EARNED					
Year	**Lowest Fifth**	**Second**	**Third**	**Fourth**	**Highest Fifth**
1970	4.1	10.8	17.4	24.5	43.3
1980	4.2	10.2	16.8	24.7	44.4
1990	3.8	9.6	15.9	24	46.6
2000	3.6	8.9	14.8	23.4	49.7
2007	3.4	8.7	14.8	23.4	49.7
% Change	**-0.7**	**-2.1**	**-2.6**	**-1.1**	**6.4**

Table 1. U.S. income by quintile, 1970-2007[3]

1 We note that inequality is ultimately about consumption opportunities; but production (income) must precede consumption, so we discuss that first, and turn to consumption in the next section.

2 We speculate that the recovery process favored political activity over economic activity, thus increasing income inequality – as did the growth of government. But the issue is sufficiently complex to make for a separate paper.

3 http://www.census.gov/data/tables/time-series/demo/income-poverty/historical-income-households.html Table H-2

Table 1 shows U.S. income divided amongst five quintiles of income earners. Note that we are intentionally using ***earner***, indicating that income is "earned" rather than "taken." Indeed, Hazlitt (1973, 186) reminds us that "the real problem of poverty is not a problem of 'distribution' but of production. The poor are poor not because something is being withheld from them, but because, for whatever reason, they are not producing enough. The only permanent way to cure poverty is to increase their earning power." We should note that in a world of high barriers to labor entry, including licensing requirements, something ***is*** indeed being withheld from the poor: the opportunity to make an honest living (we discuss this below). But in a society honoring private property and the rights of individuals, income must be earned through production, not expropriated or taken.[4] Under an economic system honoring these – capitalism – one earns by producing goods and services and trading their production (or the income earned from production) under mutually-agreed upon, voluntary terms of trade. As does Hazlitt (1973, 56), we prefer to use the more accurate expression "income variation" rather than the popular moniker "income distribution" (which implies that economic output is a given, and that some entity is taking, and then distributing, income).

From Table 1, we see that there has been an obvious increase in income variation in the U.S. The share of income earned by the lowest quintile of earners has fallen from 4.1% to 3.4%, a drop of 0.7% of the total, from 1970 to 2007. Likewise, the share of income of the bottom four quintiles has also fallen. The share of income earned by the highest quintile increased from 43.3% in 1970 to 49.7 percent in 2007, an increase of 6.4%. It is beyond dispute that income variation has increased in the past 40 years. It is also beyond dispute that the highest quintile of earners is earning almost half of national income.

However, some observations are worth noting about this quick snapshot. Income mobility is a bigger, separate question; but we note here that a majority of people in the bottom 20% have also been in the top 20% sometime in the past 30 years. Less than 1% of the American population remains permanently in the bottom 20% of income earners. Of those in the middle quintile in 1996, 42% moved to a higher quintile by 2005, 25% went down, and only one third remained in the middle quintile (Sowell 2015, 182).

Horwitz (2015) notes the importance of looking at the dynamic aspects of income distribution, and in particular, upward mobility in the US: "the story is the same for most US households:

4 Assuming the US is indeed a capitalist system, although one third to one half of the economy controlled (directly or indirectly) by the state, and political activity increasingly rewarded over economic activity. We discuss the effects of cronyism below.

they enter the income ladder near the bottom and, over time, work their way up through several of the quintiles. As existing households move up the ladder, the bottom is filled in by new households just entering the process. That's why more households can move up than down – the set of households changes year to year."[5] The numbers are the same for the poorest as for the middle class. Iceland (2013, 48) reports that 45-59% of those in poverty are in poverty for only one year, 70-84% for four years or less, and only 12% of those in poverty remain there for 10 or more years.[6] This indicates high fluidity within the distribution, a fact that is linked to life cycle patterns on both earnings and expenditures.

As we look at statistics, we also must be careful about the typical data used, which measure households rather than individuals. For instance, there are 39 million people in the bottom 20% of households, while there are 64 million people in the top 20% of households.[7] While there may be good reasons to choose household income over individual income, we simply want to acknowledge that assumptions will significantly affect these statistics. Given the passions surrounding income variation, this is particularly important to address forthrightly.

Poverty and Inequality: Are We Asking the Right Questions?

The major question that is sidestepped by the statistics on income variation is the distinction between *absolute* income, and *relative* income variation – that is, the lot of the poorest and their ability to purchase basic necessities, rather than their status compared to others. Perhaps the biggest puzzle – and marvel – lies in explaining how large swaths of humanity slipped the chains of poverty at all. To be blunt, until the mid-18th century there was too little income for anyone to worry about questions of "proper" variation. For almost all of humanity, the norm was deep, omnipresent, and dire poverty. Income disparities have been common for thousands of years, and were far more egregious prior to the growth of modern capitalism (see Sowell 2015, 1). What, then do income disparities over the past 40 years tell us – and what do they hide about the deeper, more important problem of poverty?

5 For an alternate explanation to income disparity – beyond upward mobility or cronyism, see Goodhart et al. (2015), who simply point to demographic trends affecting returns to labor versus capital.

6 Iceland (op. cit.) also indicates that there is a high risk of return to poverty. I leave details to further work.

7 On household composition generally, see Russ Roberts, „Inequality and Stagnation," http://cafehayek.com/2012/02/inequality-and-stagnation.html

	SHARE								
Year	**Lowest Fifth**	**Second**	**Third**	**Fourth**	**Highest Fifth**	**GDP**[8]	**% Change**	**GDP/CAPITA**[9]	**% Change**
1970	4.1	10.8	17.4	24.5	43.3	4269	n/a	24,000	n/a
1980	4.2	10.2	16.8	24.7	44.4	5839	37%	30,000	25%
1990	3.8	9.6	15.9	24	46.6	8033	88%	37,000	54%
2000	3.6	8.9	14.8	23.4	49.7	11226	162%	*46,000*	92%
2007	3.4	8.7	14.8	23.4	49.7	13206	209%	52,000	117%
% Change	**-0.7**	**-2.1**	**-2.6**	**-1.1**	**6.4**		x3		x2

Table 2. US income by quintile, with real GDP growth, 1970-2007

We can start this discussion by looking at table 2, which replicates table 1, but with the addition of inflation-adjusted (real) US GDP and US GDP/capita for the years in question. We have already noted changes in income disparity over that time. But it is also important to note that real GDP in the US increased *by a factor of three* between 1970 and 2007. Contributing factors included a dynamic economy that achieved productivity gains, globalization of trade, significant advances in technology, increased workforce education, and accumulations of capital (including complementary capital that further increased labor productivity). This means that from 1970 to 2007, while the lowest fifth of earners in the U.S. did earn a slightly smaller slice of the economic pie, they were enjoying a slice from a much larger pie. Specifically, the lowest fifth of income earners in the US, from 1970 to 2007, went to earning 0.7% less of national income, but that income had increased by a factor of three. The gains are slightly lower if we account for population growth by examining GDP/capita, instead of GDP, but the general lesson is

8 Billions, 2005 dollars

9 Billions, 2005 dollar (rounded average over four quarters); https://fred.stlouisfed.org/tags/series?t=gdp%3Bper+-capita%3Busa

the same. This pattern holds true for all four of the bottom quintiles of income; each earned a slightly lesser ***relative*** share of a real national income that had tripled – we will return to these ***absolute*** gains below. This is particularly important because, those at the bottom of the income variation benefit the most from general growth; as Hazlitt (1973, 53) explains, if "everybody's real income doubles… the marginal satisfactions of those at the bottom of the income scale are increased by more than the marginal satisfactions of those at the top. The latter merely buy more luxuries, or save more; the former can afford more necessities. Hence even a merely proportional increase in unequal incomes tends to reduce inequalities in real welfare. Or to put it another way, the proportional inequalities tend to mean less."

	Mean Income in 2010 Dollars				
Year	**Lowest Quintile**	**Second**	**Third**	**Fourth**	**Top Fifth**
1970	10,854	29,403	47,348	66,740	118,155
1980	11,808	29,388	48,494	71,444	127,381
1990	12,608	31,723	52,399	79,003	153,315
2000	13,979	34,903	58,125	90,357	195,803
2007	13,205	33,656	57,120	90,435	192,014
Change	**22%**	15%	21%	36%	**63%**

Table 3. US mean income by quintile, 1970-2007[10]

A similar result comes from table 3, which shows inflation-adjusted mean income in the US from 1970 to 2007. Not surprisingly, given the tripling of the size of the economy, mean income has increased significantly for all quintiles. For example, the inflation-adjusted mean income of the lowest quintile of earners went from $9,982 to $12,147, a real increase of 22%. While income gains have indeed been largest for the top quintile, we should also note that mean income has increased by 15 to 20% for the lowest three quintiles, and has increased for all quintiles. In short, the oft-stated and well-trotted idiom that "the rich are getting richer, while the poor are getting poorer" implies that only the rich have gained. This static view of economics as a zero-sum game is as inaccurate as it is misleading.

10 http://www.census.gov/data/tables/time-series/demo/income-poverty/historical-income-households.html Table H-3

Year		Inflation-Adjusted Median Income	Growth
1970		47,281	n/a
1980		48,518	2%
1990		52,684	11%
2000		57,790	22%
2007		57,423	21%

Table 4. Inflation-adjusted US median income growth, 1970-2007[11]

We now turn to table 4, which gives data on real median income. In 1970, inflation-adjusted median income was $47,281; in 2007 that figure had increased by 21% to $57,423.

One last point rounds out our analysis of income variations: the drop in the consumption gap. "Poor Americans today live better, by…measures [of consumption] than did their middle class counterparts in the 1970s" – "as a result, inequality of consumption is far less than inequality of income or wealth" (Horwitz 2015). This increased consumption comes from several sources: first, worker productivity gains (leading to increased purchasing power per hour of work); second, lower inflation-adjusted prices for many of the goods consumers purchase, due to greater manufacturing productivity;[12] and third, diminished barriers to trade, which have allowed producers to produce at lower opportunity cost, and thus lower prices (Horwitz 2015). It is important to note that the first two factors originate in physical and human capital accumulation, a point to which we return below.

Horwitz (2015) gives examples of the impressive changes in consumption opportunities.[13] A basic bundle of household appliances cost the average worker 885.6 hours of work in 1959, versus 170.4 hours of work in 2013.[14] During that time, the "hours-of-work" cost at the average

11 http://www.census.gov/data/tables/time-series/demo/income-poverty/historical-income-households.html Table H-6

12 Between 1987 and the first quarter of 2017 real output in manufacturing rose by approximately 85% while employment in that sector fell from 17.5million to 12.4million . < http://www.pewresearch.org/fact-tank/2017/07/25/most-americans-unaware-that-as-u-s-manufacturing-jobs-have-disappeared-output-has-grown/>

13 A counter-argument to this line of reasoning holds that consumption is a skewed measure, because the poorest are financing this consumption with debt. We acknowledge that low savings rates, loose monetary policy, lax lending standards, and shifting norms on debt are worthy of further research. For present purposes, we note that income has increased, and prices have diminished, so the rising income gap hides a falling consumption gap.

14 Beyond consumer goods, Horwitz (2015) also discusses the rising real prices of healthcare, housing, and education. He notes that all three of these sectors are heavily subsidized and regulated, which accounts for the rise in price. And, at least for healthcare and housing, the quality of goods available has increased dramatically, along with the price; the same is not true of education, where professional administrators and government bureaucrats are increasingly impeding teaching in

worker's wage fell from 100.5 to 23.3 for a washing machine; 90.9 to 20.7 for a dishwasher; and 127.8 to 20.7 for a color TV – and all these examples do not even consider quality change within the goods themselves. This is compounded by considering one extraordinary fact: the "whole range of items commonly found in US households, including poor ones, that ***did not even exist*** a generation ago" (Horwitz 2015). The readily available necessities of today's millenials was the stuff of science fiction for their grandparents.

Another way of looking at the increased consumption available to the lowest-income groups involves looking at the percentage of households that had certain consumer goods just 30 years ago versus now. In 1984, 58.2% of poor households had a washing machine; in 2005, 68.7% did (and 84% of all households; Horwitz 2015). During that same period, household ownership of air conditioners in the lowest income groups went from 42.5% to 78.8%; for computers (not including smart phones), from 2.9% to 42.4%, and the list goes on. Similarly, Iceland (2013, 27) notes that food expenditures have fallen from 1/3 to 1/8 of income for the average American household in the past century; the USDA reports that, from 1970 to 2007, food expenditures as a percentage of income fell from 14% to 9%.[15] In sum, the consumption baskets available to ***all*** income quintiles in the US have expanded rapidly in real ways, with diminished costs and increased quality. Again, we are not trying to dismiss poverty in the US (poverty, after all, is our primary motivation), but to contextualize it.

The Cost of Fighting Inequality

Is Income Inequality a Problem in the First Place?

Given our claim in the previous section – that there has been a clear increase in the ***absolute*** well-being of all income quintiles, just as ***relative*** income inequality has increased – it bears pausing a moment to examine some of the rationale behind the prevalent deep concern for income inequality. We identify three potential problems with income inequality.

First, there seems to be a tribal, visceral reaction against inequality, generally. To many, it just doesn't seem right that some should have more than others (see Schoeck 1987 on envy). But some level of inequality is inevitable. Indeed, people are diverse in many ways, including their interests, abilities, skills, luck, and choices in consumption versus saving. Relativist perspectives

favor of process. We leave details to a separate paper.

15 USDA, Economic Research Service, Food Expenditure Series, Table 7. http://www.npr.org/sections/the-salt/2015/03/02/389578089/your-grandparents-spent-more-of-their-money-on-food-than-you-do

can easily lead towards a spiraling trap of envy without perspective on the real, tangible, and absolute improvements in the lives of the poor (improvements that we consider to be insufficient, and that we want to expand, rather than worrying about relative standing). We argue instead that ***relative*** standing is a distraction from a much more important question: the level of ***absolute*** well-being in our society, and specifically of the poorest among us. Beyond obscuring the real problem of absolute well-being, envy leads to greater demands for redistribution at the ballot box. This is problematic because redistribution slows the very economic growth required to lift the poorest out of poverty, and creates a cycle of unintended consequences. But it is also problematic because redistribution leads to an idea trap: bad ideas lead to bad policies; in turn, bad policies lead to bad outcomes; the wrong ideas are blamed, and more bad policies are adopted. Bad ideas, bad policies and bad outcomes thus become mutually reinforcing (Caplan 2003). In this case, the redistributive state blocks growth and favors political activity over economic activity, thus concentrating income at the top. Voters blame markets and demand more redistribution (and thus more government control of the productive process); redistribution thwarts growth and increases inequality, but voters blame markets and demand even more intervention. The cycle continues – and the only way to break it is to scale back government impediments to wealth creation and access to jobs.

Second, there are concerns about the health of the polity, and social cohesion within a democracy that exhibits high levels of inequality.[16] It is certainly true that high income disparities have historically been associated with concentrations of power at the top and suffering at the bottom. Most of the great revolutions of the 18th, 19th and 20th centuries either originated in, or were fed by, income inequality. The problem is that these revolutions typically replaced one form of interventionism (feudalism or mercantilism) with another (socialism or communism); the lot of the poor was not enhanced by these revolutions (which typically expanded the power of the state, but changed the groups in power) – but by capitalism and rule of law (when they were finally adopted). Indeed, commercial power can temper absolutism in political power. The great communist countries of the 20th century engaged in widespread and persistent democide. As Friedman (1967) explains that political power has a natural tendency to centralize, whereas commercial power has a natural tendency to decentralize:

> Economic power can be widely dispersed. There is no law of conservation which forces the growth of new centers of economic strength to be at the expense of

16 Parenthetically, this makes the roots of modern democracy in ancient Athens quite odd. Indeed, discussions of income equality among the writers of the era are scarce and the consensus of historians is that social and economic inequality was wide (de Ste. Croix, 1981; Arabaster, 2002; Cavanaugh, 2009; Liddel, 2009).

> existing centers. Political power, on the other hand, is more difficult to decentralize. There can be numerous and small independent governments. But it is far more difficult to maintain numerous equipotent small centers of political power in a single large government than it is to have numerous centers of economic strength in a single large economy. There can be many millionaires in one large economy. But can there be more than one really outstanding leader, one person on whom the energies and enthusiasms of his countrymen are centered?

Where commercial power joins hands with political power – today's cronyism[17] – political power enables and exacerbates these problems. We also argue that political capture is a primary consequence of government expansion, not of income inequality – and income inequality is primarily a consequence of government inequality, as political activity comes to be favored over economic activity. As we explain below, state efforts to redistribute wealth contribute to absolute poverty. A powerful state is more likely to engage in cronyism of all types, relative to a weak one, thus increasing income inequality – even if the stated purpose was the reduction of income inequality.

Third, we acknowledge a vast literature that finds a relationship between inequality and lower growth, lower mobility, lower financial stability, and a host of social ills.[18] We argue, however, (a) that the real problem is poverty and reduced opportunity to produce; and (b) that efforts to reduce inequality will inevitably backfire.

A Thought Exercise: The Cost of Redistribution

To illustrate the unintended consequences of redistribution, let us assume that lower income variation is a national priority – to be pursued with eyes wide open and a sober recognition of tradeoffs. Assuming the redistribution is successful (a benefit, according to our assumed national priority), there will also be costs. First, there will be a bureaucracy assigned to collecting and redistributing the income, and there will necessarily be some expense in establishing and maintaining such an agency. Second, a redistribution of income from top earners will create disincentives to activities that build earnings. This is likely to occur through both investment and labor channels (how much will depend on the details of the redistribution scheme). Top earners will earn less because of the redistributive taxation itself; but they will also reduce their labor and entrepreneurial efforts in response to the lower marginal returns from those efforts.

17 We prefer „cronyism," „democratically-enabled cronyism," or „government-granted privilege" as more accurate wording than „crony capitalism" (which isn't really capitalism). The protection of economic privilege is enabled by political power.

18 For a summary, see https://www.brookings.edu/wp-content/uploads/2016/06/overstating-inequality-costs-winship.pdf

Likewise, top earners will tend to invest marginal income at a higher rate than lower earners, who will tend to spend more (or all) of their marginal dollars.[19] Government redistribution of income from higher earners to lower earners may temporarily help the lower earners, but this will decrease investment, and thus capital growth, productivity, and overall growth. As we explained above, overall growth is required for poverty alleviation, and benefits the poorest the most.

The cumulative effect will be less growth in countries that forcibly redistribute wealth. Results and details vary and are subject, of course, to empirical study, but the principle remains that every action, no matter how desirable, involves both benefits and costs.[20]

We now turn to table 5 (adapted from Tomasi 2012, 235). In this hypothetical example, assume a society with a 4% annual growth rate ("Growth Society"). In a parallel "Redistribution Society," government redistribution of income will cause growth to fall to 2% per year – for the reasons cited above, income redistribution will reduce the overall levels of economic activity and growth. In some base year (1910), the richest third in Growth Society earn $4,000, the middle third $2,000, and the poorest $1,000. After a century of growth at 4%, the poorest will earn about $50,000 per year, about one quarter of the $200,000 earned by the most productive third.

19 In more technical language, the MPC (marginal propensity to consume) varies with income levels – and with distribution of income (see Carroll, Slacalek and Tukuoka 2014).

20 Mitchell (2005) goes into greater detail, listing the following costs of government intervention: the extraction cost, the displacement cost (as private-sector activity is crowded out), the negative multiplier cost (as regulations impose higher costs than just the enforcement of the regulations), the behavioral subsidy cost (as government creates perverse incentives), the behavioral penalty cost (as government discourages good behavior), the market distortion cost, the inefficiency cost, and the stagnation cost (as government thwarts innovation and growth). We have intentionally not gone into this level of detail.

		GROWTH				REDISTRIBUTION		
			4% growth				2% growth	
Year	**Years Elapsed**	**Poor**	**Middle**	**Rich**		**Poor**	**Middle**	**Rich**
1910		1,000	2,000	4,000		1,500	2,000	3,500
1920	10	1,480	2,960	5,921		1,828	2,438	4,266
1930	20	2,191	4,382	8,764		2,229	2,972	5,201
1940	30	3,243	6,487	12,974		2,717	3,623	6,340
1950	40	4,801	9,602	19,204		3,312	4,416	7,728
1960	50	7,107	14,213	28,427		4,037	5,383	9,421
1970	60	10,520	21,039	42,079		4,922	6,562	11,484
1980	70	15,572	31,143	62,286		5,999	7,999	13,998
1990	80	23,050	46,100	92,199		7,313	9,751	17,064
2000	90	34,119	68,239	136,477		8,915	11,886	20,801
2010	100	**50,505**	101,010	202,020		**10,867**	14,489	25,356

Table 5. A Tale of Two Countries: Redistribution and Growth

Redistribution Society successfully diminishes income inequality, by redistributing $500 from the richest third to the poorest third. Thus, we see incomes of $3,500 for the most productive third, $2,000 for the middle, and $1,500 for the least productive. Redistribution Society grows at 2% per year. At the end of the century, the lowest third is earning about $11,000, just slightly less than half of the $25,000 earned by the richest third.

Which society is more desirable? Clearly, Redistribution Society has less income inequality. However, the poorest in Growth Society have an income that is *five times* higher than the poorest in redistribution society. To put this in contemporary context, 2015 GDP per capita for the US was roughly $50,000, while $11,000 approximates the GDP per capita of Egypt. *Ceteris paribus*, who is better off? Somebody earning the GDP per capita of contemporary Americans in a less equal society? Or somebody earning the GDP per capita of Egyptians, in a more egalitarian society. In fact, the US has a higher income inequality than Egypt, so the example does mirror reality.[21]

21 https://www.cia.gov/library/publications/the-world-factbook/rankorder/2172rank.html

Of course, this example is simplified, and is primarily meant as a thought exercise. We have simply assumed a cost of redistribution (which will vary in reality, depending on circumstances and policy details).. We intentionally sidestep questions of inflation and purchasing power (there will presumably be upward pressure on prices in Growth Society) – but these are compensated by questions of productivity gains and higher capital accumulation (leading to downward pressure on prices in Growth Society). Some citizens may derive psychic utility from a more equal distribution of income – but that more equal distribution will come at a cost for the poor (are the happy citizens aware of this? Are they willing to accept this cost?). The point, for now, is simply to ask whether the reduction of income inequality is a desirable policy, once we have accepted the reality of the costs of that redistribution – and the absolute lot of the poorest.

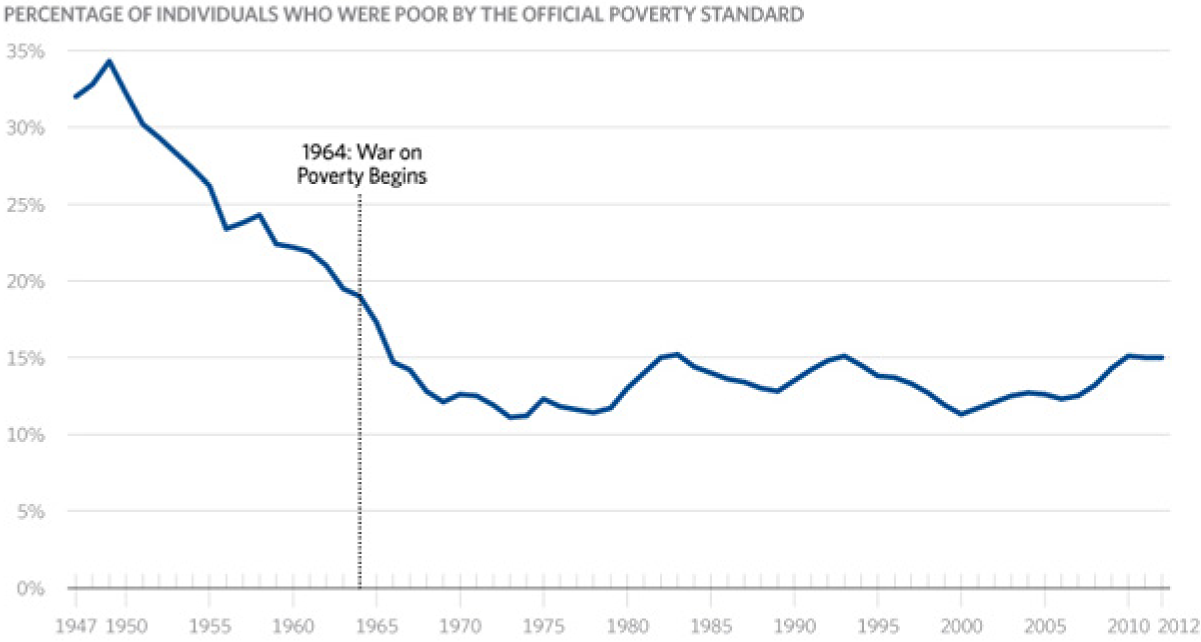
3.3 The Knowledge Problem: Planned Chaos in a World of Good Intentions[22]

Hayek (1945) explained that policymakers largely lack the information to understand – let alone fix – the workings of a complex market economy. In a market, entrepreneurs require information about which goods and services consumers wish them to produce. This information is generated and transmitted through the price mechanism (Read 1958). Thus, even if policymakers have good intentions – which may, or may not actually be the case[23] – we must be wary of the dynamics of intervention: intervention in one market distorts the epistemic function of prices (Horwitz 2015) and blocks the knowledge-generating functions of the market (Mises 2007[1955]). This leads to a distortion in related markets… followed by calls for intervention to fix the newly-affected market… and the cycle continues. As we will see, interventionism – even with the noble aspiration of reducing inequality – has a direct and visible cost, especially on the poorest.

3.4 The Welfare State and Poverty: Lessons for Income Inequality

We have already seen that redistribution and the rise of the regulatory state impede growth and thus hurt the poorest (who need growth the most). The next problem is government attempts to reduce poverty.

22 See Mises 2007[1947]
23 See Buchanan and Tullock 1962 or Bastiat 2012[1850].



Sources: Figures for 1947-1958: Gordon Fisher, "Estimates of the Poverty Population Under the Current Official Definition for Years Before 1959," U.S. Department of Health and Human Services, Office of the Assistant Secretary for Planning and Evaluation, 1986. Figures for 1959-2012: U.S. Census Bureau, Current Population Survey, Annual Social and Economic Supplements, "Historical Poverty Tables—People," Table 2, https://www.census.gov/hhes/www/poverty/data/historical/people.html (accessed September 10, 2014).

Figure 1. US Poverty Rates, 1947-2012[24]

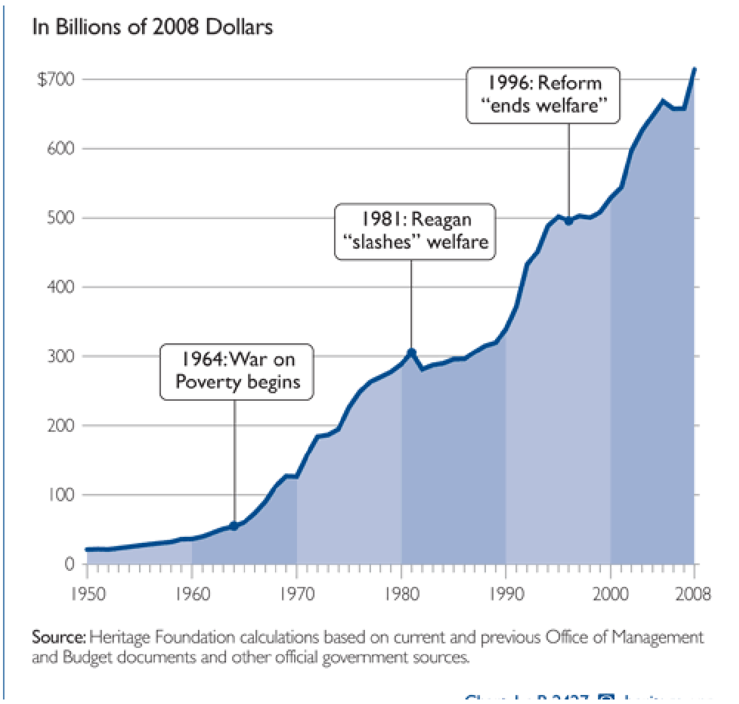


Figure 2. Welfare Spending (1950-2008)[25]

24 http://www.heritage.org/multimedia/infographic/2014/09/poverty-rate-1947-2012
25 http://www.heritage.org/research/reports/2010/06/confronting-the-unsustainable-growth-of-welfare-entitlements-principles-of-reform-and-the-next-steps

Figure 1 shows US poverty rates since 1959. Note that the rate of poverty, was falling – ***significantly*** – before the US government took aim at poverty in 1964. By the mid-1960s, when President Johnson's Great Society was launched, the poverty rate in the U.S. had already fallen below 15%, thanks to the post-war recovery and prosperity. Despite 50 years of federal government involvement, the rate of poverty remains right about at 15% today, the point to which it had already fallen ***before*** the Great Society efforts. The ineffectiveness of the federal war on poverty is also highlighted by figure 2, which shows total welfare spending since 1950. Over the half century in which the federal government has been actively fighting poverty, to the tune of more than $1 trillion in 2015,[26] national poverty rates have not changed.[27] While federal welfare programs may not be solely responsible, there is certainly a compelling parallel pattern of government growth, lingering poverty, and increasing income disparity.

Why would government efforts at fighting poverty be unsuccessful (or even detrimental)?

Take the example of wage controls. Minimum wage laws cause unemployment, but the problem is especially prevalent among uneducated and unskilled workers who are priced out of the market. The primary role of an entry-level job is to acculturate neophyte workers to the norms and expectations of the workplace; entry-level workers almost never provide as much value to employers as they are paid. Wage controls affect both the processes and likelihood of entry-level positions in the work force. These are crucial to further human capital developments – a lack of opportunity in these jobs can have long-lasting, pernicious effects on work force participation over a lifetime. Indeed, most households in the bottom quintile have nobody working (Sowell 2015, 168). From an employer's perspective, as Hazlitt (1973, 147) explains, "we cannot make a man worth a given amount by making it illegal for anyone to offer him less. We merely deprive him of the right to earn the amount that his abilities and opportunities would permit him to earn, while we deprive the community of the moderate services he is capable of rendering."

More generally, the welfare state provides disincentives to work, and increases income inequality: "to the extent that the expanding welfare state allows more people to live without working – and therefore without earning income or developing their own human capital – supporters of the welfare state are contributing to the very income disparities they so much decry" (Sowell

26 This includes federal, state and local spending. This does not include indirect welfare spending like education, Social Security and Medicaid. http://www.usgovernmentspending.com/entitlement_spending

27 Of course, one might argue the counter-factual, that poverty rates would have been higher than 15% today, there but for government involvement. But why assume a sudden reversal of the pre-1965 trends, especially considering that the economy has grown by a factor of almost four?

2015, 168; see Hazlitt 1973, 230-231). Tanner and Hughes (2013) share an apocryphal quip about "cliff points" (when workers lose net income by earning more, because they lose welfare benefits): the "highest marginal tax rate for anyone in the US [is] for a person leaving welfare for work." Consider the following facts from Tanner and Hughes (2013):

- Welfare pays more than minimum wage in 35 states
- In 13 states, welfare pays more than $15/hour
- In 8 states, welfare pays more than the median income; and in 40 states, welfare pays 80% or more of the median income
- Only 2.6% of full-time workers in the US are poor; but 15% of part-time workers and 24% of non-working adults are poor
- Less than 42% of adult welfare recipients are actually working (despite the 1996 welfare reforms)
- There are currently 126 federal anti-poverty programs in place in the US

These figures simply reflect the moral hazard problems associated with significant wealth redistribution by the government. The creation of dependency among able-bodied adults (and the political spoils associated with the process) has been a problem long recognized by several thinkers (Tocqueville 2015[1835], 23-25 and 35; Hazlitt 1973, 71 and 185-186; Sowell 2015). Yet it persists.

Moving from the micro- to the macro-level, government spending crowds out private enterprise and investment, and thus capital accumulation and growth. In the years "1995-2012, OECD member countries that increased government expenditures as a percentage of GDP grew 30% slower than member countries that trimmed government expenditures as a percentage of the economy over that span – average annual growth of 1.9% compared with 2.5%."[28] As we have seen above, it is precisely the poorest who benefit the most from economic growth.

28 „The Mythical Link between Income Inequality and Slow Growth," Matthew Schoenfeld, *The Wall Street Journal*, October 12, 2015, http://www.wsj.com/articles/the-mythical-link-between-income-inequality-and-slow-growth-1434319942

While welfare policies in the U.S. may arguably have some short-term palliative effect, they also do not encourage investment in human capital, and have done little for income mobility (see Hazlitt 1973, 56 and chapter 10).

In closing, we add a brief commentary on regulation that is officially for the public good. The cost for Americans to comply with federal regulations has reached about 10% of GDP. This represents resources that are diverted away from productive investments, job creation, and productivity gains, with a regressive impact (Thomas 2019). In the specific case of employment regulation, approximately 1/3 of Americans today require occupational licenses, up from 5% in the 1950s. The Institute for Justice reports that "on average, these licenses force aspiring workers to spend nine months in education or training, pass one exam and pay more than $200 in fees. One third of the licenses take more than a year to earn." This kind of job licensing will typically be regressive, as those with higher incomes are more able to pay for the required courses, exams, and other licensing fees than will be those at the bottom end of income, and especially those who were attempting to enter the job market.

Having examined what does not work, we discuss alternative solutions to poverty in the conclusion.

Crushing Innovation: From Luxury to Banality

At best, the government is ineffective in its anti-poverty efforts. At worst, these efforts have caused the poorest of Americans to be partially excluded from national productivity gains. If government efforts at fighting *poverty* have been counter-productive, we would expect the same from government efforts to fight inequality. Indeed, Hazlitt (1973, 49) notes that income inequality was already falling in the two decades before grand government action in the 1960s, and has been rising since. This is the crux of the problem.

Hazlitt (1973, 123) explains that the progressive taxation used to fight inequality disproportionately seizes funds that were destined for investment, rather than consumption – thus ultimately hurting the poor more than the rich. Lower investment means diminishing growth in productivity, capital accumulation, job creation, and innovation – all of which also dampen decreases in real consumer prices. In sum, investment is the greatest form of charity (Hazlitt 1973, 2).

Redistribution has consequences for investment – and thus (as we have seen) consumption by the poorest. Because top earners have more disposable income, they purchase the luxury goods of today that become the standard features for the rest of us tomorrow. Luxury purchases by the rich help to drive innovation, allowing entrepreneurs to invest in production and bring those goods to the market at lower prices, thus making them accessible to the middle class, and eventually to all. Hayek (1960, 43-44) summarizes the point nicely: "A large part of the expenditure of the rich, though not intended for that end, thus serves to defray the cost of the experimentation with the new things that, as a result, can later be made available to the poor... Even the poorest today owe their relative material well-being to the results of past inequality" (see also Mises 1985[1929], I.5; more generally, see Bastiat 1995[1848]).

Take the example of automobiles in the early 20th century, or mobile phones in the 1990s, or smart phones and car rearview cameras in the early 2010s – all of these started as luxuries, and eventually become commonplace. Imagine the consequences of attempting to level income disparity by imposing a progressive consumption tax – as has been suggested by economist Robert Frank.[29] Taxing cell phones as a luxury in the early 1990s would have discouraged many of the few consumers from purchasing them and would have thwarted the investments that lowered their prices. For those who remember the "bricks" of the 1990s and the "flip phones" of the early 2000s, the transformation has been nothing short of miraculous. Today's smart phone penetration rate approaches 80%[30] – that's not just 80% of Americans who can now peruse pictures of family, friends, and pets on Facebook, instantly chat with their Instagram friends, or enjoy other entertaining frivolities. More significantly, it also represents cheap and easy access to the internet for school research, job searches, or online non-traditional banking. The last is an especially pertinent point. High banking costs – largely driven by federal regulations in the wake of the 2008 financial crisis – keep an estimated 10 million Americans unbanked, and 20% of American households underbanked.[31] Fortunately, non-traditional banking (on smartphones) presents an alternative.

Horwitz (2015) explained (above) that the consumption gap has been falling steadily over the past 40 years; but that gap would be increased by redistributive efforts. Schumpeter (1942, 67-68) elegantly summarizes the issue:

> The capitalist engine is first and last an engine of mass production which unavoidably also means production for the masses. . . . It is the cheap cloth, the

29 „The Progressive Consumption Tax: A Win-Win Solution for Reducing American Income Inequality." December 7, 2011. http://www.slate.com/articles/business/moneybox/2011/12/the_progressive_consumption_tax_a_win_win_solution_for_reducing_american_economic_inequality_.html

30 http://www.marketingcharts.com/online/smartphone-penetration-nears-80-of-the-us-mobile-market-65214/

31 https://www.forbes.com/sites/realspin/2014/08/04/how-to-help-the-unbanked-repeal-the-durbin-amendment/#5afbea5b71ad

> cheap cotton and rayon fabric, boots, motorcars and so on that are the typical achievements of capitalist production, and not as a rule improvements that would mean much to the rich man. Queen Elizabeth owned silk stockings. The capitalist achievement does not typically consist in providing more silk stockings for queens but in bringing them within reach of factory girls.

Conclusion

Income inequality exists in the US, and it has clearly been increasing in the past 40 years. However, it would be incomplete to look only at income inequality. The poorest of Americans are better off in the US than they were 40 years ago – but they would also be much higher, had government expansion not crowded out economic growth (Mitchell 2005).

Too much poverty still remains, with no good reason (but plenty of bad reasons, from cronyism to failed government redistribution). Indeed, Hazlitt (1973, 232) bluntly reminds us that "capitalism has already eliminated mass poverty" (see also Mises 2007[1955] and 1985[1929]). Lingering poverty is thus doubly frustrating, because it is avoidable (if only we would let markets work and stop preventing the poor from earning). As Posner (1986) opines, "in a world of scarce resources waste should be regarded as immoral" (see also DeBow 1992).

The purpose of this paper has not been to dismiss income inequality entirely – but to question whether inequality is the real problem and outline the costs of changing it, including the distraction from the real issues: absolute poverty and barriers to productivity for the poor. Income redistribution, which stifles growth, is not a solution, as we have seen from the abysmal U.S. war on poverty. Any real solution to poverty must address the ability to earn. Hazlitt (1973, 209) reminds us, once again, that the real solution is not government relief, but an increase in productivity; "one is ashamed to keep repeating anything so obvious, but the only real cure for poverty is the production of wealth."

For the sake of the poorest of Americans, it is of vital importance that policymakers not make the same mistakes in addressing income inequality as they have made in attempting to address poverty over the past half century. As Hazlitt (1973, 125) foresaw, "any attempt to equalize wealth or income by forced redistribution must only tend to destroy wealth and income." In sum, "the promotion of economic equality and the alleviation of poverty are distinct and often conflicting" (Bauer 1981, 23).

The point here is not to abandon the poor – quite the contrary. But, rather than engaging in redistributive programs with unintended consequences, governments can do two things: first, get out of the way, and stop thwarting the market's wonderful process of growth; and second, let civil society handle those who fall through the cracks of the market.[32] In sum, markets create more wealth, and they do so more effectively and more evenly than government intervention.

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32 See Beito 2000 on a century of voluntary, fraternal mutual aid efforts – efforts that were effectively killed by the rise of the welfare state

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