GOVERNMENT TRANSFERS AND INEQUALITY: AN ANATOMY OF POLITICAL FAILURE

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ABSTRACT

Governments have long justified transfer payments in the name of reducing income inequality. The justification seems plausible and compassionate, if one takes an idealistic view of public and private incentives. Political authorities can simply take money from the wealthy with a progressive tax structure and use much of it to make net transfers to the poor, who would otherwise lead impoverished lives. Initially, this may actually seem to reduce income inequality and increase the incomes of the poor. However, political transfers soon begin motivating public and private responses that offset any equalizing effect the transfers may have upon income, and increase economic inefficiency. The long-run effects of the transfers are invariably no reduction in income inequality, fewer of the poor moving up the income ladder, and a national income smaller than it would otherwise be. This leaves the poor worse off than if the transfers had never been initiated, since they end up with about the same share of a smaller total income. Unfortunately, the poor have become both dependent upon, and victims of, the transfers, which makes it politically difficult for short-sighted politicians to improve the plight of the poor in the long run by eliminating the transfers.

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1. INTRODUCTION

It is widely believed that market economies result in excessive income inequality and that government should and can reduce this inequality to acceptable levels with income transfers. Few deny that income transfers generate some economic inefficiency. But the common argument is that up to some point (always yet to be reached) the social gain from a more just income distribution more than offsets the cost of reduced efficiency. Also people assume, at least implicitly, that this trade-off between inequality and inefficiency is stable, so policy makers can choose a combination of reduced inequality and increased inefficiency that society prefers to that combination resulting from market forces.[1] One is reminded of the Phillips curve, once assumed to represent a stable trade-off between inflation and unemployment which policy makers could consider in choosing the best mix of the two.[2]

We argue that the trade-off between inequality and inefficiency, as with the Phillips curve trade-off, is not stable, and any attempt to reduce inequality at the cost of a little inefficiency, while possible in the short run, is unlikely to succeed in the long run. Just as attempts to reduce unemployment with a little inflation soon result in escalating inflation with little or no reduction in unemployment, so attempts to reduce inequality with transfers at the cost of a little inefficiency soon result in escalating inefficiency with little or no reduction in inequality. The existence of the transfers creates incentives that motivate politi-

[1] Okun (1975) famously described government transfers from the rich to the poor as a "leaky bucket," and he does not mention the possibility of the leak in the bucket getting larger over time.

[2] See Friedman (1968) and Phelps (1968).

cians, organized interests, recipients and taxpayers to react in ways that reduce economic efficiency and reverse any reduction in income inequality that initially resulted from the transfers. The result is harmful to people in general, but particularly so to the poor supposedly being helped. They end up with no larger share of the pie, as inequality is not reduced, and their constant share will be from a pie smaller than it would have been otherwise because of the reduction in efficiency.

Also, once the political process has traveled very far down this transfer road, it becomes very difficult to undo the harm by reducing the transfers. The difficulty in reversing the transfers is explained by a combination of short-sighted political incentives, compassion for the poor by voters, and organized groups with private concerns that have nothing to do with inequality. This does not guarantee that transfer policies are irreversible. But, it does suggest that when transfers are reversed, the reverse will be small, and the transfers to the poor are more likely to be reduced than the transfers to the non-poor.

In the next two sections we argue that there is a "natural" rate of income inequality that is more resistant to transfer policies than is commonly recognized. While transfers can reduce income inequality in the short run, persistent and strong public and private forces work to move inequality back to its natural rate. These forces work not only to frustrate political attempts to reduce income inequality, but to reduce economic productivity below what it would have otherwise been. In Section 4, by continuing to distinguish between the long run and the short run, we consider the most common argument for the claim that government transfers increase the income of the poor. In Section 5 we develop a graphical model that illustrates an unfortunate political equilibrium based on the political attractiveness of attempts to reduce inequality with transfers, even though the result is little or no long-run reduction in inequality and a reduction in the well-being of the poor below what it would have been without the transfers. The model also illustrates why it is politically difficult to reverse transfer policies that have failed. Concluding comments are offered in Section 6.

2. GOVERNMENT TRANSFERS AND POLITICAL COMPETITION

Without government transfers to reduce income inequality, market competition would generate a level of inequality whose long-run trend would be quite stable, where long run can be measured in decades, and probably longer. Empirical measures of income inequality such as the Gini coefficient, for example, change very slowly over time, with no clearly discernable long-run trend. This suggests that there is what can be considered a natural rate of income inequality. No one would argue that this natural rate of inequality is perfectly stable. Demographic shifts, technological improvements, immigration patterns, medical improvements, measurement approaches, and any number of other factors can affect the income distribution as commonly measured.[3] Ignoring measurement distortions, these changes are likely to roughly offset each other, with income

[3] Common measures of income inequality are often misleading. For example, measuring income inequality by comparing the share of income going from the highest to the lowest quintile of household income can show increasing inequality even when there has been no change. This is explained by the reduction in the number of people in low-income households relative to the number in high-income households. For a useful discussion of this and other distortions in measures of income distribution, see Rector and Hederman (2004, p. 4).

inequality experiencing moderate fluctuations around a rather stable value—rather like the natural rate of unemployment, which, while subject to change, is quite stable over time intervals relevant to most public policy considerations.

We now ask: what is the effect of government transfers on the natural rate of inequality? We shall argue that the answer to this question is very little, if any at all. Income transfers can, and probably do, reduce inequality in the short run. But, over time government transfers lose their equalizing effect as the political and private forces pull inequality back toward its natural rate. Our argument is based on two considerations: 1) political motivations for, and responses to, income transfer programs, and 2) private responses to those programs. This section considers the first consideration in two subsections. But first, a brief comment on political competition and compassionate voting.

Our argument on the effects of political transfers on income inequality centers on political competition for those transfers. Almost by definition, the chronically poor are not very effective at competing in the marketplace. Because of the combinations of education, skills, attitudes and ambition, connections, etc. they possess, their productivity is inadequate to earn an income sufficient to escape poverty. This suggests what we consider an important question, but one seldom asked: Are the poor any more effective at competing in the political process than they are in the marketplace? There are at least two reasons why this question is almost never raised. First, while most people see market outcomes resulting from competition between different people and interests, they tend to see political outcomes as resulting from people (voters, politicians, and government employees) putting their private interests largely to one side to achieve some common social objective, such as helping the poor.[4] Second, they believe that while there is political competition, it is a much fairer form of competition since the political currency—votes—is far more equally distributed than market currency.

We contend that the best way to understand the political process and compare it realistically with the marketplace is by assuming that people are fundamentally the same whether making political or market decisions. We see no compelling reason to believe people are less motivated by self-interest in the political arena than in the marketplace.[5] The type of competition that results differs because the rules are different, but the poor are no more favored by political competition than by market competition.

Some observations on voting behavior are commonly seen as refuting the claim that, as voters, people are as self-interested in making political decisions as in making market decisions. People routinely vote for policies (or for political candidates advocating them) for helping the disadvantaged that, if passed, will be personally costly. S. Kelman (1987, pp. 255-259) cites examples of such voting, and argues that this refutes the claim that people vote consis-

[4] Kelman (1987, p. 22) expresses this view by arguing that "our political institutions work to encourage public spirit. There is the elementary fact that political decisions apply to the entire community. That they do encourage people to think about others when taking a stand." On the same page he continues, " Claims must become formulated in terms of general ethical arguments about rights, justice, or the public interest,…., to stand any chance of being convincing to others."

[5] The ubiquitousness of self-interest in both political and market settings is the fundamental premise of public choice, as emphasized in the seminal work by Buchanan and Tullock (1962). For a more recent discussion of public choice and the role of self-interest in political decisions, see Shughart (2008).

tently on the basis of self-interest. We accept the empirical reality of such voting, but believe that it is consistent with self-interest, does little to reduce income inequality, and helps explain why the poor are ineffective at political competition.

Self-interest can motivate both donors to, and poor recipients of, government transfers to vote for those transfers in sufficient numbers to make them politically viable. The self-interest motivation of recipients is obvious; the self-interest motivation of donors less so. Few will deny that most people realize a sense of satisfaction from feeling generous. Like other goods, however, there is a downward-sloping demand curve for the feeling of generosity, and more will be purchased the lower its cost. Voting greatly lowers the cost of feeling generous. As opposed to making a private contribution to help the poor, voting to help the poor in an election is effectively costless, since the probability that one vote will determine the outcome of an election is, in state and national elections, vanishingly small. For example, if one "votes" to give $25.00 to the Salvation Army, that "vote" is completely decisive, and the cost to the individual is $25.00. On the other hand, if one votes for a government proposal to make transfers to the poor that, if passed, will cost her $1,000, the cost is $1,000 times (x) the probability that the other voters are evenly split. If, choosing an unrealistically large value, this probability is 1/10,000, the expected cost of voting for the transfer is ten cents—a real bargain for the warm glow of generosity when one walks out of the voting booth after casting an expressive vote.[6]

[6] A wide range of implications from the low probability of any one vote being decisive are discussed in Brennan and Lomasky (1993), who coined the term "expressive voting," and Caplan (2007), who talks about voting in terms of what he calls "rational irrationality."

Such expressive voting for helping the poor is far from the end of the story on how much help the poor will receive. It may look like the poor and the good-hearted win over the stingy and hard-hearted once a majority votes for expanding, or creating, a transfer program for the poor. Don't be so sure, however. First, how good-hearted does one have to be to vote for generosity that costs almost nothing? Second, much of the support for public transfer proposals, and the effort to make them appeal to the public's "compassion," is likely to come from interest groups far more concerned with helping themselves than with helping the poor. Once the public voting is over, these interest groups become even more active, and then the real political competition begins. This competition does not favor the poor.

2.1 COMPETING FOR TRANSFERS TO THE POOR

Interest groups are in a position to profit from government transfers supposedly made for the benefit of the poor. Industry groups can benefit when the goods and services they sell are given to the poor as in-kind transfers, the non-poor can benefit from expansions in transfers to include them, and consulting firms and academic researchers can benefit from studying the effectiveness of the transfer programs. These interest groups are often well positioned to influence the details of transfer programs, and their influence increases over time. Relatively small groups with a common interest can more easily overcome the free-rider problems associated with taking effective political action than can the general public.[7] Also, government agencies

[7] See Olson (1965).

administering transfer programs are the natural allies of special-interest groups wanting those programs expanded, even if the expansion benefits the non-poor. These administering agencies are politically potent interest groups themselves, but are always anxious to have effective support for maintaining and expanding their budgets.

The effectiveness of interest groups concerned with government transfers generally increases over time. They are strongly motivated to stay focused on influencing the details of transfer programs in ways that benefit them, and they can expect little opposition from those who are primarily concerned with the welfare of the poor. After the vote favoring transfer programs, even those voters genuinely concerned with helping the poor will soon turn their attention to other concerns.

One might object that organized interest groups also have genuine concerns for the poor, and are willing to sacrifice personal gain to help the poor, just as voters are. This is likely true. Indeed, most of those in the interest group may be more concerned for the poor than the average person who votes for transfer programs. As opposed to voters, however, the interest groups' choices are quite likely to have a decisive influence on how the transfer programs are structured. Their decisiveness makes it very costly for them to use their influence to "vote" against their interests to favor the poor. So despite the concern they may have for the poor, expect political influential interest groups to act with a healthy regard for what is good for their members.

There is ample evidence of the effectiveness of the non-poor at tapping into transfer programs initially justified in the name of helping the poor. Many transfers to the poor are made in the form of particular goods and services provided by, and benefiting, the non-poor. The most important examples of these in-kind transfers involve public housing, medical care, education, energy and food stamps. Well over half of all government transfers to the poor are in-kind transfers. No one denies that these transfers are worth having, but cash is worth more to the recipients because it gives them more freedom to choose what they value most. The argument for in-kind transfers rather than cash is that the poor cannot be trusted to spend money wisely. But if the goal is to help the poor as much as possible, far more people would be given cash than are now, fostering in recipients a sense of some responsibility, while dealing with flagrant cases of irresponsibility when they arise.[8]

When a government program is being considered to transfer income to the poor, it often attracts the interest of the non-poor, who lobby effectively to have the program expanded to benefit them as well. When federal legislation to provide medical care to the poor was being considered in the 1960s, there was also pressure to expand the help to older Americans, the vast majority of whom are not poor. Both Medicaid (providing government financed health care to the poor) and Medicare (providing health care to those over 65 years old) were signed into law on July 30, 1965. Since then both programs have grown, but expenditures on care to the elderly have grown faster than has care to the

[8] Milton Friedman long recommended a negative income tax, which, in lieu of most in-kind transfers, would have transferred income to people and families when their income fell below a minimum level. But when Congress was considering such a proposal it never overcame the interest group pressures favoring the continuation of in-kind transfers, which caused Friedman to oppose the bill. For a discussion of Friedman's opposition, see Friedman and Friedman (1998, pp. 381-82).

poor. An important reason for this is that, as opposed to Medicare that is financed entirely by the federal government, Medicaid is partly financed by states, which can ease the eligibility requirements to help the non-poor and then shift much of the extra cost to the federal government. In some states, a family of four with an annual income of over \$61,000, triple the poverty rate, is eligible for Medicaid benefits.[9] Also, many non-poor elderly have been able to qualify for the long-term care provided by Medicaid (but not by Medicare) through provisions in the law that don't count the value of some assets (homes, for example) as part of a person's wealth, and legal arrangements allowing people to transfer much of their wealth to their children.[10]

A somewhat similar pattern occurred when Canada began providing universal health coverage in the late 1960s with the Canadian National Health Insurance (CNHI) program. According to Lindsay and Zycher (1984), the expansion of public financed health care for everyone in Canada through the CNHI was paid for largely by cutbacks in social programs focusing benefits on the poor. Lindsay and Zycher's econometric analysis indicates that because of these cutbacks, the poor in Canada paid for approximately 33 percent of the CNHI.

Other examples of the poor being outcompeted for government transfers initially justified on their behalf are found in state-funded higher education. State government

[9] See Markowitz (2007).

[10] A more recent federal health care program that was initially targeted to the poor, but which was expanded to provide benefits to the non poor is the State Children's Health Insurance Program (Schip). A further expansion in funding for Schip was vetoed by President George W. Bush.

support for colleges and universities favors the non-poor, since those pursuing higher education are overwhelmingly from middle-to-higher-income families. This fact has been used to justify government programs to provide special financial assistance to qualified students from lower-income families. In the early 1990's, for example, Georgia passed HOPE (Helping Outstanding Students Educationally), a state-funded scholarship program that, beginning in fall 1993, provided full college tuition and books to Georgia students from families with an annual income of less than \$66,000. This motivated political pressure to provide the same assistance to students from higher-income families, and so the limit was raised to \$100,000 for fall 1994. The political pressure for a higher limit continued from those with even higher incomes, and in fall 1995 the limit on family income was removed entirely. Interestingly, the HOPE scholarships in Georgia are paid for with lottery revenues, which, as a percentage of income, come disproportionately from the poor.

Of course, no one can deny that governments transfer a lot of income to the poor. Even if the poor are not very effective in the competition over the details of the government transfers clearly aimed at helping them, they surely receive most of the aggregate benefits from them. If only those transfers are considered, it might be reasonable to conclude that they reduce income inequality below what it would be otherwise. But the non-poor are also competing for transfers that harm the poor and increase income inequality.

2.2 COMPETING FOR TRANSFER IN GENERAL

The most effective competitors for government transfers, broadly defined, are business and occupational groups. They possess all the characteristics needed for effective political competition mentioned earlier: a relatively small, well-organized membership, all of whom have a strong common interest that can be furthered by political action.

A significant percentage of government transfers go to businesses owned primarily by people who are financially well off, and managed by people who are extraordinarily well off. These transfers are commonly referred to as “corporate welfare.” A recent study by Slivinski (2007) estimated that the federal government spent $92 billion on corporate welfare during the 2000 fiscal year, where such welfare is defined narrowly to include only “direct and indirect subsidies to businesses and private-sector corporate entities” (Slivinski, p. 2). Most of this corporate welfare goes to the non-poor. For example, IBM Corporation received $49.2 million in federal grants from 1991 to 2005; General Electric received $32.2 million; and Honeywell International received $29.0 million (Slivinski, Table 2 on p. 9).[11] In fiscal year 2006 the federal government paid farmers $21 billion in crop and farm subsidies (Slivinski, p. 6). In 2005 (the most recent year for which the data are available) the richest 10 percent of farm subsidies received 66 percent of the total value of those subsidies (Slivinski, p. 7).

Of course, a large amount of money transferred by government does not go to corporations and is commonly discussed as if it reduces income inequality by helping the

[11] Table 2 contains the federal grant amounts received by 36 Fortune 500 companies from 1991 to 2005. Certainly not all the shareholders of these companies are rich, but most of the benefits from the federal grants went to those owning the most stock, or those who are financially very well off.

poor. But the non-poor get most of this money, with political influence being the major factor determining the distribution of these transfers. In 2000, the federal government transferred $1.07 trillion, but only $312 billion (about 29 percent) was means-tested—eligibility subject to income limits.[12] The other 71 percent—about $758 billion in 2000—was distributed with little attention to need. The most important example is Social Security. In 2000, Social Security retirement payments of $353 billion (over 46 percent of non-means-tested government transfers during that year) were made to the elderly regardless of their wealth. Elderly families have roughly twice the net worth, on average, of non-elderly families. This left another $405 billion in government transfers going to people in 2000 no matter how large their income or great their wealth.

Once we consider all government transfers, and not just those to the poor, it is clear that the poor are being outcompeted for government largess. Of course, one can argue that the poor don't pay as much in taxes as the wealthy, and so they can still come out ahead. This may be true, but there are qualifications worth considering. First, while poor families pay a smaller percentage of their income in federal income taxes than rich families (the federal income tax is progressive[13]), the federal income tax accounts for only around 25 percent of all taxes paid at all levels of government, and much of the remaining revenue comes from taxes that are not progressive, and are often regressive (taking a

[12] See Rector (2001, p. 2). Even transfers that are means-tested commonly go to those who are not poor, since the income limits are often higher than the poverty level.

[13] The income tax is not as progressive as the rates indicate since wealthy tax payers can more easily reduce their taxable income than poor taxpayers.

larger share of the poor's income than of the rich's income). State income taxes are less progressive than the federal income tax. Second, the percentage of the poor's incomes that goes to sales taxes is just as high, and often higher, than the percentage of the rich's incomes. Also, a higher percentage of the income of the working poor goes to Social Security taxes than does the income of the wealthy, although some argue that this is offset somewhat by the higher monthly Social Security payments received by the poor per dollar than they pay in payroll taxes. However, the poor start working earlier and don't live as long as the non-poor, and therefore pay into Social Security longer and receive the retirement benefits for fewer years than the non-poor. Finally, excise taxes on such items as cigarettes and alcoholic beverages take a larger percent of income from the poor than from the rich.

Even if all taxes were progressive, they would not take as much from wealthy workers as most people believe. Workers supply their services more in response to after-tax income—the amount they can spend themselves—than they do to before-tax income. So when income tax rates are increased on the most productive workers, attracting these higher-paid workers requires that employers pay them even more before-tax income to offset, at least partially, the higher tax rates on their incomes. Highly-paid workers are worse off because of progressive taxes, even with their higher pay, but not as much worse off as most people believe.

Regardless of how progressive the tax system is, or how much money it transfers to government authorities, political competition will assure that the poor will receive less of the tax revenue than the non-poor who are better at political competition. Even if the net effect of government taxes and transfers is to take money away from the rich, and give it to the poor, it does not follow that the long-run result is a reduction in income inequality. As we argue in the next section, private responses to government transfers also operate to neutralize any effect those transfers might otherwise have in reducing income inequality.

3. PRIVATE RESPONSES TO GOVERNMENT TRANSFERS

Neither those who receive government transfers for the poor nor those who pay for them are passive in response to those transfers. Their responses reduce the amount that is transferred and the benefit the poor receive from what is transferred.

First consider the response of the recipients. In a nutshell, the recipients of government transfers to the poor will end up substituting publicly provided income for privately earned income. There are both short-run and long-run dimensions to this substitution. Some people will make choices that reduce their immediate, or near-term, earnings because of the opportunity offered by government transfers—for example, by not taking a job, dropping out of school, or getting pregnant. Some, of course, will qualify for transfers for reasons beyond their control, or at least temporarily beyond their control, and will find the temptation to accept the available transfers difficult to resist. Whether or not the choice to begin receiving transfers has the immediate effect of reducing a recipient's earned income, the longer-term effects of being on welfare can reduce earned income below what it would be otherwise. It is true that many people who receive government transfers for the poor do so only temporarily and are not deterred from choices that increase their income-earning potential. But once someone begins receiving transfers predicated on being poor, he or she is faced with incentives that increase the chances of remaining poor.

People receiving transfers for being poor face higher marginal tax rates on earned income than any other income group. When a poor person receiving government assistance increases his income, he starts losing eligibility for some of that assistance. Even if the loss from the additional dollar earned is moderate when any one transfer program is considered (this is not always the case), when there are multiple programs involved (as there often are), the marginal loss can be quite high. It can easily happen that when the loss from several income transfer programs is considered, earning an additional dollar actually reduces a person's income—the marginal tax rate is greater than 100 percent. Such a marginal tax has an immediate and negative effect on a poor person's willingness to earn money. And this short-run effect has more serious implications in the long run by discouraging the development of skills and attitudes that increase a person's productive potential over time.

There is also a connection between government transfers to the poor and crime. Wilson (2002) cites a number of studies that find a clear positive link between the degree to which communities are dependent on transfers and destructive criminal behavior. A plausible explanation is that government transfers, particularly to single women with children, have reduced the sense of responsibility to marry and support their offspring with productive activity that social norms have traditionally imposed on men. This connection between transfers and crime undermines the income-earning potential of the poor immediately, but this connection is even more corrosive over the long run. Studies find that males raised without their biological fathers are seven times more likely to go to prison than those raised in stable families that include their biological fathers.[14] This suggests that even if welfare transfers did increase the incomes of the poor in the short run, they could still reduce their incomes in the long run by reducing upward income mobility among the poor. So studies that concentrate on the effect of welfare transfers on inequality at a point in time (as most discussions of income inequality do because of data limitations) surely overstate the ability of transfers to reduce lifetime income inequality. Lifetime income inequality is a more meaningful measure of inequality of wellbeing, with possible exceptions in cases of extreme, even if temporary, privation.

However, it is not clear that welfare transfers do much to reduce income inequality even in the relatively short run. When time limits were imposed on certain transfers to the poor (most notably, Aid to Families with Dependent Children) by the Personal Responsibility and Work Opportunity Reconciliation Act of 1996, many opposed this Act with the argument it would cause an increase in crime and financial hardship among the poor. These concerns may have been excessive. Brown, Montoya and Dayton-Schotts (2004) found that despite the reduction in welfare transfers, there was a decline in criminal behavior and substance abuse in poor neighborhoods. A more recent study by the Congressional Budget Office (2007) reported that the overall inflation-adjusted incomes of poor families with children had increased from 1991 to 2005, with the inflation-adjusted earning from salaries and wages of the poorest 20 percent of families increasing more over that period (78 percent) than the salaries and wages of any other quintile of families, including the richest 20 percent. Most of the increased earnings of the poor since 1991 took place

[14] See Wilson (2002).

after the 1996 welfare reform, with the decline in cash income from welfare transfers for poor families being more than offset by the increase in earnings.[15]

In addition to the substitution of publicly provided transfers for privately earned income by poor recipients, private responses to government welfare transfers by the non-poor also reduce any net income the poor receive from government transfers. In particular, increases in government transfers to the poor reduce private contributions to the poor. In the 1970s Abrams and Schmitz (1978) estimated that private charity fell by 28 cents for every one-dollar increase in government welfare expenditures. It is true that not all of the private charity went to helping the poor, but surely some of it did. And Roberts (1984) has argued that, beginning in the 1930s, the composition of charity giving shifted away from the poor in response to the growth in general government transfers in the belief (largely mistaken) that the situation of the poor was being effectively addressed by government. More recently Brooks (2000) cites studies estimating that an additional dollar of government support for nonprofit organizations reduces private donations by as much as 50 cents. Interestingly Brooks (2006, pp. 55-57) cites evidence indicating that spreading the belief that government has a responsibility to reduce income inequality, regardless of whether how effectively government carries out this responsibility, re-

[15] It should be acknowledged that there was a general reduction in the crime rate beginning in the 1990s, with factors other than the welfare transfers no doubt playing a role in this reduction. Also, there was robust job growth during the last half of the 1990s that surely improved earning prospects for low-income people after the 1996 welfare reform. Indeed, we argue in Section 5 that the positive effect of reducing welfare transfers can take quite a long time to be fully realized.

sults in (or is at least associated with) reductions to private charities, including those helping the poor.

Without making a case that private transfers to the poor are less likely to foster dependence and productive choices than public transfers, we still have to conclude that the money going to the poor from increasing public welfare transfers is less than it appears because of the negative effect on private transfers to the poor. If private transfers are more effective at improving the long-run prospects of the poor, the crowding-out effect of public transfers is even more pronounced.

4. HAS GOVERNEMNT REDUCED THE INCOME INEQUALITY?

Given the effects of political competition for government transfers and the response of the poor and non-poor to the government transfers that do go to the poor, the case that government has done much, if anything, to actually reduce income inequality seems weak. And if government transfers haven't reduced income inequality, it seems to follow that they haven't helped the poor. This conclusion, and the arguments in this paper, clearly challenges evidence which is commonly put forth in support of government transfers to the poor. The challenge isn't that the evidence is wrong, but that, when considered in light of our arguments, it reflects the failure of government transfers to help the poor rather than their success.

Ideally we would measure the effectiveness of government transfers at helping the poor by reducing income inequality and by comparing the income distribution of the current transfer programs with the income distribution that would have existed without those programs—with the income distribution determined entirely by market forces and private transfers. Making this counterfactual comparison is obviously not possible, although one can, as we have attempted to do, make some reasonable conjectures about the counterfactual income distribution by considering the effect of government transfers on the income of the poor. We cannot claim that our conjectures are completely accurate, but we do claim that they are more accurate than the implicit assumption commonly made by defenders of government transfers—that the privately earned incomes, receipts from private charities, and the taxes paid and economic inefficiencies suffered, are largely unaffected by government transfers. Not surprisingly, if one assumes that if transfers are eliminated the income of the poor will be reduced by almost the entire amount received from those transfers, the benefits from those transfers appear large.

For example, in a survey of the effects of public transfers on the poor, three well-respected scholars on poverty and public policy, Danziger, Haveman and Plotnik (1981, p. 1019) state that "Our review suggests that the incidence of poverty is about 75 percent lower and the Gini Coefficient about 19 percent lower than in the absence of transfers." Consistent with our point, they do acknowledge on the same page that "the redistributive studies, however, adjust for neither the replacement of public by private transfers, in the absence of the former, nor for the tendency of transfers to increase pre-transfer poverty by … reducing work effort."[16] More recently, and far more polemically, the drastic predictions by critics of the Personal Responsi-

[16] They do not acknowledge, however, that transfers to the poor and the far larger transfers to the non-poor result from the political competition and horse trading that make the former transfers dependent on the approval of the latter.

bility and Work Opportunity Reconciliation Act of 1996, clearly ignored the possibility that public transfers had reduced the income of the poor from other sources, and that this reduction would be reversed by welfare reform. K. Pollit wrote in *The New Republic*, "Wages will go down, families will fracture, millions of children will be made more miserable than ever." A *New York Times* editorial warned, "The effect on our cities will be devastating." Senator Frank Lautenberg, a Democrat of New Jersey, worried that "hungry and homeless children" would be walking our streets "begging for money, begging for food, even…engaging in prostitution." *The Nation* prophesied that "people will die, businesses will close, infant mortality will soar."[17]

The failure of the dire predictions on the consequence of reducing welfare transfers does not mean such prediction should be completely dismissed. They contain an element of truth, even if exaggerated. Reducing welfare transfers can increase the suffering of welfare recipients in the short run. This is true even if the poor are no better off (and maybe worse off) financially because of government transfers than they would have been if the transfers had never been provided in the first place.[18] Stated differently, even if the government transfers have no long-run effect on income inequality, scaling back the transfers that go primarily to the poor can, at least in the short run, increase that inequality by harming the poor. The other side of this coin

[17] These quotations come from Tanner (2006).

[18] Keep in mind that we are talking here about government transfers in general, with it understood, as pointed out in endnote 16, that transfers to the nonpoor are generated by the same political process as are transfers to the poor.

is that increasing transfers to the poor does more to help them in the short run than in the long run.

Trying to measure the effect of government transfers on the income distribution is fraught with difficulty. First, any attempt to actually measure the income distribution can never be very precise because of such considerations as unreported income, the difficulty of assessing the monetary value of in-kind payments, the locational differences in the cost of living, and the difficulty in assessing the connection between the income distribution at any particular time and the distribution over lifetimes. In addition, one never knows what the income distribution would have been in the counterfactual world without government transfers. The limited evidence that does exist provides little indication that government transfers have had a long-run effect on the income distribution. In an early study of U.S. data, Reynolds and Smolensky (1977 and 1978) found no systematic movement in income distribution between 1950 and 1970. Based on their later overview of studies on the effect of income transfers, Danziger, Haveman and Plotnik (1981, p. 978) admit that "income equality has remained relatively constant" over the period 1965-1978.[19]

Recently the media has repeatedly claimed that income inequality has significantly increased since the 1980s, with the richest 1 percent of Americans receiving 15 percent of all income, compared to about 8 percent in the 1970s.[20] If true, this claim would cast doubt on our proposi-

[19] We should point out that despite the lack of a clear relation between the income distribution and government transfers, Danziger, Haveman and Plotnik (1981) believe these transfers have helped the poor.

[20] For examples, see *The Economist* (2006) and Krugman (2006). Evidence of increasing inequality is typically cited as a justification for more government action (and transfers) to offset the unfairness of the

tion of a relatively constant natural rate of income inequality. It should also cause those who believe that government transfers reduce inequality to question their confidence in this belief. However, the measured increase in inequality since the 1980s apparently reflects little, if any, actual change in inequality, being almost entirely the result of tax changes. According to Reynolds (2007), over half of the relative increase in the percentage of income going to the richest 1 percent occurred in response to the tax reforms of the 1980s that reduced the top marginal tax rates on income from over 70 percent to 28 percent. This motivated high-income taxpayers to shift large amounts of income being sheltered as corporate income to individual income, since the marginal tax rate on the latter income dropped below the marginal tax rate on the former income after the reforms. Since corporate income does not appear in individual tax returns (which are the source of the income data used to measure income inequality), it appeared that the incomes of the rich suddenly increased when in fact they had just moved more of their income to individual tax returns where it got counted. Also, before the 1980s almost all income from investments was reported on individual tax returns and was counted as income. During the 1980s, increasing amounts of investment income went into tax-deferred retirement plans (such as 401(k)s and IRAs), with the returns not reported on tax returns until retirement. With middle-income taxpayers having a far greater percentage of their assets in these tax-deferred accounts than the rich, the result was that their reported incomes were reduced because of these accounts by a far greater percentage than were those of the rich. Also, the relative incomes of the top 1 percent compared to the incomes of others are

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market. The possibility that increasing inequality is evidence of government's inability to reduce inequality seldom gets voiced.

overstated in the studies of inequality because they don't count much of the income from government transfers going to the poor. Once these measurement errors are corrected, it appears that government policy can do more to change measured income inequality than to change actual income inequality.

Government transfers may have little, if any, systematic effect on income inequality, but they clearly have important economic effects. The taxes to finance transfers reduce the return on labor, saving and investment, reduce the incentives of welfare recipients to pursue productive activities, and distort the decisions of corporate recipients, all of which reduce economic productivity—recall Okun's (1975) leaky bucket. No one knows just how large this loss of productivity is, but estimates by Browning (1976, p. 283) on just the dead-weight loss from taxation suggest that it is "between $1.09 and $1.16 per dollar of tax revenue." So if government transfers do little to reduce income inequality, but do reduce the growth of income, it necessarily follows that these transfers have made the poor worse off—they end up with the same percentage of a smaller economic pie.

5. SHORT-RUN TEMPTATIONS AND LONG-RUN CONSEQUENCES

Next we construct a simple model of short-run political decisions that illustrates our argument that government transfers can reduce income inequality in the short run, but reduce economic productivity and have little, if any, effect on income inequality in the long run. The model shows that short-run temptations can lead to an unfortunate political equilibrium by a series of decisions difficult to reverse.

Figure 1. Short Run Political Temptations with Long Run Consequences

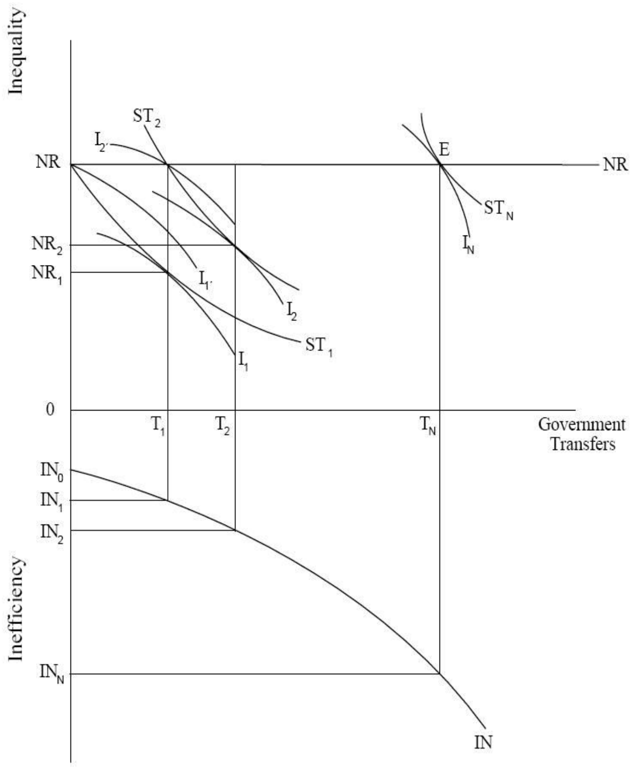

Figure 1 contains two quadrants. In the top quadrant, inequality is measured on the vertical axis and government transfers on the horizontal axis. In the bottom quadrant, economic inefficiency is measured on the vertical axis, with movement in the downward direction indicating greater inefficiency. As shown in this bottom quadrant, inefficiency is an increasing function of government transfers, with inefficiency increasing at an increasing rate as transfers increase, as shown by the curve IN. Increasing inefficiency does not mean, of course, that national income decreases with government transfers, just that it is lower than it would be because of the increased transfers. It is in the top quadrant, however, that the interesting dynamic is illustrated, assuming that the political process is more responsive to short-run incentives than to long-run consequences.

The natural rate of income inequality is given by NR in Figure 1. Assume we begin with zero government transfers and NR income inequality.[21] From this position we assume that an increase in government transfers will reduce inequality in the short run, as shown by the tradeoff curve ST_1 in Figure 1. Curve ST_1, and all the ST curves, become less steeply sloped as transfers increase, indicating that the marginal short-run effectiveness of transfers at reducing inequality decreases as they increase. The indifference curve, $I_{1'}$, that originates from the point of zero transfers and NR, and all indifference curves, I, becomes more steeply sloped, indicating that as transfers become larger, more inequality has to be reduced by a marginal increase in transfers to politically justify the increase. At zero transfers, the slope of ST_1 is shown to be more negatively sloped initially than $I_{1'}$, implying that the short-run reduction in ine-

[21] All government expenditures, no matter how justified, have distributional effects and can thus be thought of as being transfers. We are not counting all such expenditures as transfers. By transfers we are referring to government expenditures motivated by the desire to benefit some at the expense of others, although this is seldom the stated motivation. We recognize that many government expenditures result from some combination of productive and transfer motives, but we abstract from the difficulty of distinguishing between the two.

quality realized from a marginal increase in transfers is greater than what is required to compensate for the political cost. This indicates that the political motivation in the short run is to reduce inequality with transfers, moving to indifference curves preferred to $I_{1'}$ (those indifference curves with less inequality for each level of transfers). The optimal short-run level of transfers is shown in Figure 1 as T_1, where tradeoff curve ST_1 is tangent to indifference curve I_1.

The effect of the transfer level T_1 on inequality begins to erode in response to the political incentives discussed previously, with inequality increasing back to its natural rate, NR. This situation is worse than the initial position with zero transfers, since inequality is the same as before, but economic inefficiency has increased to IN_1 from IN_0, as seen in the bottom quadrant of Figure 1. Assuming that this adjustment to NR and T_1 is complete before there is a further increase in transfers, it is easy to illustrate the political temptation to increase transfers beyond T_1. Assume that at transfer level T_1 and equality rate NR, the relevant indifference curve, $I_{2'}$, is less steeply sloped than the relevant short-run tradeoff curve, ST_2, as shown in Figure 1. Again, the short-run political advantage is in expanding transfers until a new tangency position occurs, this time between the tradeoff curve ST_2 and indifference curve I_2. As before, the reduction in inequality, which is less than the previous reduction, begins to erode in response to long-run political incentives, and it eventually returns to the natural rate NR. This represents a further worsening in the inequality-inefficiency tradeoff, since inefficiency has now increased further to IN_2 and the inequality is no lower than it was initially.

Again it is likely that the short-run political incentives will motivate another increase in transfers to lower inequality below NR, resulting in a further increase in economic inefficiency with no lasting reduction in inequality. This process continues until transfers have been increased to T_N and inefficiency has increased to IN_N, where the indifference curve I_N is tangent to the tradeoff curve ST_N at the natural rate of inequality.[22] This is the long-run equilibrium (shown as E in Figure 1), since there is no longer a short-run incentive to expand or reduce transfers. This equilibrium can be thought of as an example of Tullock's (1975) "transitional gains trap" in which temporary gains entice government to pursue policies that lead to a situation that is worse than where it started, but find it difficult to move back to the original situation.

The difficulty of reducing transfers below E is obvious. The short-run effect of reducing transfers would move us up and to the left along the curve ST_N, greatly increasing inequality as the poorest, and most dependent on transfers, find themselves unprepared to quickly replace their lost transfers with private earnings. This increase in inequality would be moderated somewhat, falling below what is shown in Figure 1, if the reduction in transfers to the poor were accompanied by corresponding transfers to all interest groups (we are assuming that the transfers measuring along the horizontal axis include all transfers). When constructing ST_N we make what we believe is the realistic assumption that if there is a reduction in transfers, it will most likely be the transfers to the poorest—those

[22] As we move to the right along line NR, with increases in transfers, the slope of the indifference curves will become more negative as it will take a larger reduction in inequality to justify a given increase in transfers as transfers increase. Also, the slope of the short-run curves ST will become less negative as a given increase in transfers will generate a smaller reduction in inequality as transfers increase. So eventually the tangency between an indifference curve and a tradeoff curve will occur on the line NR.

with the least political influence—that are reduced most. So any significant reduction in transfer can be expected to cause a large increase in cases of dire poverty in the short run, which would generate enormous public pressure to restore the transfers.

The 1996 Personal Responsibility and Work Opportunity Reconciliation Act (PRWORA) may seem to be both consistent and inconsistent with this discussion of the difficulty of escaping the "transitional gains trap" represented by equilibrium E. The act did impose limits on how long parents could receive cash transfers, based on the number of children they had, as PRWORA replaced Aid to Families with Dependent Children (AFDC) with Temporary Assistance for Needy Families (TANF). To the extent that this represented a reduction in transfers to the poor, it is consistent with our claim that if transfers are reduced, they are most likely to be those going to the poor. Certainly PRWORA was not accompanied by any general reduction in government transfers. The government transfers being dispensed to the host of non-poor recipient groups continued to flow with no noticeable interruption. But didn't PRWORA represent an escape from the trap represented by E? The answer seems to be, if so, it was not much of an escape. The transfers to the poor have been marginally cut, but only marginally. AFDC was cut back, but there remain many transfers (mostly in-kind transfers) available to pick up the slack. According to Tanner (2003, p. 84), "Most of those who left the rolls and found work [not all former welfare recipients by any means as state exceptions to time limits and work requirements have been common] still remain deeply entangled in the public safety net. …. In fact, two-thirds of former welfare families continue to turn to government for assistance in meeting their health-care, food, child-care, transportation, and housing needs."

We are not arguing that the 1996 welfare reform has had no positive effects, but that it was at best a very cautious, and marginal, reduction in transfers. It was cautious and marginal because of the fear, which was likely justified, that a significant reduction would have had politically unacceptable short-run effects on poverty and income. And this explains why we feel there is only the slightest probability of a significant reduction in transfers in general in the foreseeable future, even though such a reduction would reduce economic efficiency and have no noticeable effect on inequality in the long run.

6. CONCLUSION

We predict that the arguments presented in this paper will have no effect on transfer policy for the same reasons we believe they are correct. Transfers have little, if any, effect on income inequality because most political decision makers have a mild desire to reduce inequality in the income distribution with government transfers, but an intense desire to improve their position in the income distribution with government transfers. Both the mild and intense desires are important to our argument.

As voters, political decision makers have little interest in determining if the effects of government transfers on the economic efficiency and the poor are negative. The voters' tendency to support government transfers (or those who support them) at the polls is motivated by a rather mild desire to feel good about themselves by casting a vote that costs them effectively nothing because of the miniscule probability it will affect the election's outcome. While satisfying this feel-good desire is worth more than the tiny cost of voting for transfers, it is not worth as much as the cost of following up on such a vote to determine if the transfers actually help the poor by reducing income inequality, as evidenced by the fact that almost no voters have any idea what effect government transfers have.

On the other hand, members of organized interests have little motivation to consider the effects of transfers on economic efficiency and the poor even if fully aware that they are negative. The significant influence organized interests have on the political prospects of transfer that concentrate benefits on them, motivates a strong desire to "vote" for those transfers regardless of any negative effect on others. Surely members of special-interest groups are as virtuous as most citizens (indeed most citizens are members of special-interest groups), but because their support of their own transfers is likely to be decisive, it would be very costly to condition that support on its effect on such mild concerns as reducing income inequality and helping the poor.

Effectively supporting a special-interest transfer generally requires presenting it in a way that appeals to the desire of voters to support what they consider virtuous policies. This is often not difficult, given the limited motivation voters have to investigate claims made on the effects of transfers. Not surprisingly, transfers are invariably justified as serving the public interest, which often includes helping the less advantaged. Farm subsidies are advertised as helping family farms, and struggling farmers survive; a host of American firms receive subsidies to provide goods in the form of foreign aid to supposedly help poor people in poor countries; import restrictions are claimed to save American jobs, including those of low-income workers; education subsidies supposedly help poor students get a better education; and corporate welfare is sometimes justified as necessary to protect the jobs of those in poor communities. That these programs seldom help the poor, and indeed often harm them by reducing general economic efficiency, does little or nothing to reduce the political support they receive from expressive and rationally ignorant voters.

Once transfer programs are enacted, the political competition we discussed in Section 2 begins. With this competition being dominated by organized interest groups, whose members are seldom poor and have an intense interest in the private benefits they receive from transfers, it is not surprising (as we have discussed) that this competition does not reduce income inequality or favor the poor. Our arguments, based on this political competition, imply that the long-run effect of reducing all government transfers would be to increase the well-being of the poor, since doing so would leave income inequality unaffected while increasing economic efficiency. But these same arguments also imply that no one has much motivation to pay attention to them, and even less motivation to act on them by reducing transfers. Granted, even if people were motivated to understand the arguments supporting the long-run advantages of reducing government transfers, there would still be the obstacle of overcoming the short-run costs of reducing those transfers. A necessary first step in overcoming this obstacle would be public awareness of the long-run harm imposed by transfers. But the mild interest of voters, and the intense interest of organized groups, in public transfers practically guarantees that the public is influenced by only the most straightforward and easily available information on transfers, with that information being generously made available by groups benefiting from transfers.

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