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Authors:	Hassett, Kevin A.
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Rich Man, Poor Man

How to think about income inequality. (Hint: It's not as bad as you may think)

As the 2004 campaign begins in earnest, it appears the Democrats' preferred strategy will be to tie a weak economy to President Bush's economic policies. But what will they talk about if the economy gets strong? Several pieces in the New York Times suggest the answer: income inequality. The best example is a Times Magazine piece by Paul Krugman contending that we are entering a new Gilded Age as "extravagant as the original." He recounts anecdotes of truly awe-inspiring wealth, of executives being treated like "royalty," and reports that in 1998 the 13,000 richest families had about the same combined income as the 20 million poorest households. The data are pretty striking, and reveal that income is far more concentrated at the top than it used to be. What should one do about it? Yale's Robert Shiller, writing in the Times op-ed section, proposed a law that would automatically increase tax rates on the wealthy if inequality increases.

Such drastic measures might be advisable if inequality were demonstrably harmful. But is it? I recently coedited (with R. Glenn Hubbard) a volume, Inequality and Tax Policy, that pulled together the leading research on the economics of inequality. One chapter in our book, contributed by Robert Barro of Harvard, found that inequality has a fairly unusual relationship with economic growth. If inequality is very high in a very poor nation, that country is likely to have low growth; but in wealthy, developed nations such as ours, economies have tended to do better when inequality is higher. And there is certainly no evidence that inequality results in political upheaval in such democracies: If we gave Bill Gates an extra $50 billion, it would not have a predictable effect on the typical voter's life.

Inequality matters to the voter mostly to the extent that it affects his sense of the basic justice of society. Many of the inequalities arise because of choices. Workers with unpleasant jobs are often compensated for that unpleasantness with a higher wage. But other forms of inequality, such as abject poverty, may also be the result of misfortune. In this area, redistributive arguments appear quite compelling: Hungry children will be fed everywhere if only we roll back President Bush's tax cuts.

But the president would be right to insist on the tax cuts. Consider an example first suggested by Milton Friedman in his landmark book Capitalism and Freedom that I take some liberties with here. Imagine a small tropical archipelago with three islands. We drop one individual on each island, and each faces dramatically different circumstances. One of the islands is densely forested with fruit and coconut trees and provides a pleasurable life of leisure to its inhabitant. Another has sufficient fish in its lagoons to provide sustenance, but only to a hard-working fisherman. The third is a barren wasteland, and the poor individual who lands there can barely survive by eating insects.

Now imagine that you have been appointed governor of this archipelago. Should you move everyone to the nice island? Should you seize resources from the lucky fellow and give them to the insectivore? A typical response might be that the different outcomes are purely the result of luck, and hence have no moral standing. Government could enter and make the poor better off -- and is justified in doing so, since the wealthy fellow would want there to be redistribution if he had landed on a different island.

If this example is not extreme enough to arouse such a response in you, then let's revise it to try to change your mind. Suppose that a young child lands on the bad island and will die if we do not take some food from the good island. Should government act now?

So there are cases where inequality is a worthy motivation for government action. But before we book our flight to Sweden, let's change the scenario again. Suppose that each island is identical, with arable land but little else. One fellow builds a palatial farm and dines on fine foods grown on his property. The other two do not develop their islands, but sit around enjoying the beach all day, sustaining themselves with insects. Given the different circumstances, has your favored government policy changed? A typical answer might be that the lazy beachcombers don't deserve the hard-earned fruits of the farmer and should be left to their bugs.

In the real world, differences emerge between citizens because of both luck and choices. Virtually every circumstance is a mixture of these two cases. This distinction is important, because it makes it difficult if not impossible to conceive of scenarios where justice clearly supports forceful redistribution. Moreover, since effort is almost always part of the picture, it is likely that redistribution will be counterproductive even from the perspective of the poor. After all, governments play a dynamic game. If we take away the fruits of effort today in the name of social justice, there will be fewer fruits tomorrow. If we discourage entrepreneurs from starting new businesses today with our highly redistributive taxes, then tomorrow's poor might not be able to find a job and could well go hungry.

These concerns are magnified if governments are potentially corrupt. If a person yields a portion of his freedom to government, how can he be sure that other freedoms will not also be lost? There is no guarantee that we would not all end up with absolutely equal incomes locked away in a gulag.

Thus the question of social justice is an empirical one. If we redistribute now we may make some folks better off today, but we may also undermine economic growth and create an authoritarian government that opposes our freedoms. Nobody wants to live in a world of hungry children, but which view of the world leads to the policy that produces the fewest cries over time?

From a global perspective, the evidence is quite clear: Freedom wins. Columbia economist Xavier Sala-i-Martin recently published a paper that carefully explored the evolution of world poverty and income inequality over time. He found that inequality and poverty have declined sharply, with the steepest decline occurring after 1980 (a year that may sound familiar to Reaganites). The figures are striking: The number of individuals with a real income below $2 a day dropped about 40 percent (affecting 400 million individuals) between 1980 and 2000. Why the big shift? Sala-i-Martin found that the movement of many countries (especially China) away from socialism and toward free-market capitalism had a profound effect on economic growth and the welfare of the poor. As societies abandoned the pursuit of absolute equality in favor of the pursuit of liberty, growth emerged and the poor benefited.

On a different scale of poverty, it is also true that the Western European nations with large welfare states have had abysmal economic records -- with the bigger socialist nations, France and Germany, posting economic growth over the past decade about 1 percentage point below that of the U.S. Compound that difference for decades and even folks in the bottom of the U.S. income distribution will be better off than the typical Frenchman. So which society will deliver a better life to the poor?

At the micro level, one will always be able to find individual cases that challenge conservative dogma. Ten years from now, many fewer people will live in poverty if growth -oriented tax policies are enacted -- but confiscatory taxes could undoubtedly address evils that exist today. My colleague Robert Hahn has calculated that, statistically speaking, an extra 40 years of life could be provided to some U.S. citizen if life-saving government programs were increased by $3.8 million. Accordingly, one could conceivably give 40 years of life to 10,504 Americans by confiscating Bill Gates's income and dedicating it all to targeted government programs. Posed that way, how could one allow Mr. Gates to keep his money?

Of course, the problem is solved if private charity arises without the coercion of government, and Mr. Gates has an excellent record in that regard. But if we leave that aside, conservatives are left defending unfettered capitalism with the argument that it produces a world in which 400 million individuals worldwide can rise permanently above poverty in just a few decades, in part because transitory fixes are eschewed. This position is sound, but even Friedman had difficulty with the tradeoff: "The fact that these arguments against the capitalist ethic are invalid does not of course demonstrate that the capitalist ethic is an acceptable one. I find it difficult to justify either accepting or rejecting it, or to justify any alternative principle. I am led to the view that it cannot in and of itself be regarded as an ethical principle; that it must be regarded as instrumental or a corollary of some other principle such as freedom."

Freedom wins because it is desirable in itself and because its presence has so soundly advanced social justice. Defending it requires dogged reference to long-run goods that far outweigh the benefits of quick fixes.

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By Kevin A. Hassett

Mr. Hassett is director of economic policy studies at the American Enterprise Institute.
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