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GOVERNMENT REVENUES AND EXPENDITURES IN THE UNITED STATES ECONOMY

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CHAPTER 18

TAXATION AND REDISTRIBUTION

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CHAPTER 18

TAXATION AND REDISTRIBUTION

Well over half of the federal government budget goes toward redistributive activities of some type. Programs that are directly redistributive, such as Social Security, Medicaid, and unemployment compensation, make up the bulk of the federal government's redistributive expenditures. Programs such as farm price supports were created with the intention of increasing the incomes of farmers, and subsidized school loans and housing loans redistribute income to the recipients of those loans. Almost any government program has a redistributive component to it, but one does not have to stretch the definition of redistribution to see that most of the federal government's expenditures are undertaken with the intention of directly improving the welfare of specific groups of people. Programs like national defense and the interstate highway system provide benefits that are general enough that they fall outside the category of redistribution, but, in the 1990s, these types of programs make up a minority of federal expenditures.

This chapter examines the philosophy underlying the government's efforts at redistribution and examines some of the effects of government redistribution programs. Chapter 19 then looks at other redistribution programs, and chapter 20 specifically analyzes Social Security, the government's largest redistribution program.

PRINCIPLES OF TAXATION AND REDISTRIBUTION

The chapters that analyzed the tax system looked at specific types of taxes, and the tax system as a whole, in terms of efficiency and equity but only touched on the concept of the tax system itself as a mechanism for producing a more equitable society. The implied model of taxation in the previous chapters was the fiscal exchange model of taxation, in which taxes represent the price that is paid for public sector output. In determining how that price should be paid, the two criteria of equity and efficiency came into play. The tax should impose as little excess burden as possible, following the principles of efficiency, and should be shared fairly among the taxpayers, following the principles of equity.

The benefit principle leaves little room for redistribution

This view of taxation is consistent with the model of government as a type of club in which citizens are bound together by an agreement that enables them to collectively produce goods and services that the market would not otherwise provide. Taxes pay for public sector output. Frequently, however, the tax system and public sector spending move beyond the production of public sector output and actively pursue the social goal of income equality. Although the tax principles of equity underlie such actions, they extend beyond simply seeing that everyone pays her fair share of the tax burden. The government might also undertake social policies to transfer benefits to those in society who are less fortunate, with the goal of making them better off. Of course, such social policies are financed by the tax payments of those who have higher incomes. In short, the goal of government redistributive programs is to use the resources of some taxpayers to improve the welfare of others.

Note the conceptual division of principles of tax equity here. According to one concept of equity, everyone pays a fair share of the cost of government. According to the other concept, those who are less well off have benefits redistributed to them from the tax payments of those who are better off. The benefit principle clearly applies to the first category of taxation, but the ability-to-pay principle might apply to either category. It can be argued that a person who is more able should pay a larger share of the tax burden. But it can also be argued that a person who is more able to pay is under some type of social obligation to help those who are less fortunate and thus should pay more in taxes to redistribute income. This chapter deals with some of the basic issues of income redistribution as an activity of public finance.

The ability-to-pay principle opens the possibility of transfers from those with more ability to pay

A number of questions regarding redistributive issues must be addressed, but those questions can be divided into three basic categories. The first concerns the motivation for redistributive government programs. Why is there a demand for them? What are the possible justifications for government redistribution? The second category of inquiry deals with the results of redistribution programs. What are their effects? Do they really help those they are intended to help? How should these programs be designed? The third category deals with the incentive structure implied in the redistribution programs. What types of behavior are encouraged by redistribution, and how do the programs affect the way that the government in general is run?

EQUALITY AS A SOCIAL GOAL

Many people view equality of income and wealth as a social goal that the government should try to further through its taxation and spending policies. In a general sense, the fact that some people live in luxury while others in the same society (or the same world) live in poverty may be thought of as undesirable for many reasons, each of which has different policy implications. Because a society can, through government, create social policies, an understanding of why inequality in income or wealth might be regarded as undesirable can point the way toward appropriate remedial actions.

Furthering income equality and helping those in poverty are two different goals

Redistributive programs by definition involve the transfer of benefits to those less well off in a society, but there can be two substantially different motivations for undertaking these transfers. One motivation is to create more income equality, so the goal is to lessen the differences between rich and poor. A second motivation is to help out those who are less fortunate and who are having trouble taking care of themselves, so the alternative goal is to improve the welfare of those who are least well off. Although both goals might be furthered by transferring resources from rich to poor, the motivations are obviously different, and oftentimes the policy implications of the two goals are very different. If the goal of redistribution is to help out those who are less fortunate, one should not be concerned about the degree of income inequality but only about the welfare of those who are least well off. If the goal is greater income equality, in most cases income equality can be more easily achieved by lowering the well-being of those who are best off rather than raising the well-being of those who are worst off.

Consider a public policy that would lower everyone's income but that would lower the income of the rich by a greater percentage than the income of the poor. This policy would further the goal of equality but would work against the goal of helping out those who are less fortunate. Similarly, a policy that increased everyone's income but that increased the incomes of those at the top end of the income scale by a greater percentage than those at the bottom would work against equality but would further the goal of helping those who are less well off. Which is the better goal to pursue? That is a normative question, and there may be legitimate reasons to pursue both goals. But it is rare to find someone who favors equality without also favoring the goal of helping out those who are less fortunate. If the issue is analyzed in this way, helping those in poverty is a more generally accepted normative goal than furthering income equality.

Redistributional programs tend to be targeted mainly toward people in the same nation that undertakes the programs, although some international redistribution does take place through government. From a normative standpoint, what value judgments must be made in order to favor the poor in the redistributing nation over those in other nations? The United States is relatively prosperous, and poor people in the United States typically fare much better than the poor in many other nations. Why would the U.S. government be relatively generous to the poor in the United States rather than giving more help to people who are much worse off in other nations?

The goals of alleviating the effects of poverty and of creating more income equality are very different, and the main reason for considering the issue is that many people have not thought about it, and they subconsciously equate policies that create more income equality with policies that raise the incomes of the poor. But policies that create equality by making the rich worse off typically have the by-product of lowering the productivity of the economy, which can work against the interests of the poor. Thus, when considering policy issues that have a normative foundation, like redistribution, it is important to carefully identify the goals of such policies. Helping the poor is not the same thing as creating more income equality.[1]

Equality of Opportunity and Equality of Results

In applying the general concept of equality to the discussion of redistribution, we must first distinguish between equality of opportunity and equality of results. In the United States, some government policies are designed to produce equal opportunity, whereas others are designed to produce equal results. Often the distinction is not clearly made. The desire to provide equality of opportunity is not a desire to give everyone equal income or wealth but rather is a desire to give everyone an equal chance. In this sense, it is analogous to the desire for a game with fair rules, but not necessarily a game that ends in a tie. Equal opportunity, as the term implies, simply means that everyone starts off with the same chance.

Obviously, inequality can result from rules that do not provide equality of opportunity. The now-defunct caste system in India, apartheid that existed through the early 1990s in South Africa, and governmental rules that enforced racial segregation in parts of the United States through the 1960s are all examples of inequality of opportunity. Often, even though the rules do not specifically establish inequality, discrimination can still occur if some individuals are not provided with the same opportunities as others based solely on characteristics such as gender or national origin.

Fair Rules and Fair Outcomes

The inequality that results from discrimination is generated by social conditions that are not considered to be fair. An analogous situation would be a game in which the rules favored some players over others. The obvious solution is to change the rules so that everyone has an equal opportunity. Recall the device of the veil of ignorance used by John Rawls to describe what constitutes a fair social structure.[2] Rawls theorizes that all individuals, before knowing anything about their financial status, social position, level of intelligence, athletic ability, race, gender, and so on, must agree to the rules of the society. Rawls argues that rules that could have been agreed upon behind this veil of ignorance are fair rules.

Fair outcomes are the result of fair rules

Although one can see that there may be some disagreement among those of us not behind the veil of ignorance as to what might actually be agreed upon, the principle seems clear. Everyone should be subject to rules that can be agreed upon as fair.

The questions about how the government should implement fair rules are clearly normative. For example, should there be high inheritance taxes, so that some individuals do not start off with an unfair advantage because of inherited wealth, or do inheritance taxes unfairly deprive the wealth holder of the opportunity to pass on wealth to heirs?

1 For a discussion, see Edgar K. Browning, "Inequality and Poverty," *Southern Economic Journal* 55, no. 4 (April 1989): 819–30.

2 John Rawls, *A Theory of Justice* (Cambridge, Mass.: Belknap, 1971).

If one strongly favored equality of income, an inheritance tax would appear desirable, whereas if one wanted to preserve the incentive to create wealth without regard to equality, it would not. Would a progressive income tax be agreed to behind a veil of ignorance? If so, at what rates? Although these questions do not have clear-cut answers, what is important here is to recognize that the desire for equality of opportunity is merely a component of the desire for overall equality. Equality of opportunity demands fair rules, but it does not necessarily require that income be transferred from some individuals to others.

THE GOAL OF EQUALITY

Equality of opportunity is generally accepted as a normative goal of social policy, but many individuals feel that equality of opportunity is not sufficient and that the less-than-equitable results of equality of opportunity warrant the implementation of income redistribution policies. This leads to the argument for government taxation and expenditure policies that create a more equal distribution of income. Because the policy implications may differ depending upon why one favors government redistributional programs, it is worthwhile to examine the possible reasons why a more equal distribution of income could be viewed as desirable.

Utilitarian Justifications

The first reason stems from the concepts of utilitarianism and the social welfare function that were introduced in chapter 2. Recall that the utilitarians believed that the utility of one individual could be measured and compared with the utility of another individual. In this context, social utility is the sum of all the individual utilities in a society. If there is diminishing marginal utility of income, then the higher one's income, the less utility is derived from additional income. Therefore, total social utility can be increased by transferring income from high-income individuals (with a low marginal utility of income) to low-income individuals, who will receive more utility from the income. In short, to maximize social utility, the government should transfer income from high-income individuals to low-income individuals.

Economists today do not believe that utility is directly comparable among individuals, but a similar concept is embodied in the notion of a social welfare function. The social welfare function can be thought of as a utility function for a society as a whole, and it admits the possibility that social welfare can be increased by income transfers. The idea has been most explicitly expressed in a body of literature known as optimal taxation, in which a social welfare function compares the utilities of individuals and, in general, determines that a society can maximize its social welfare if income is distributed more equally.[3] Complete equality would not be desirable in this view because the excess burden of taxation from the redistribution would lower GDP so

If rich people get less utility from an extra dollar than poor people, then redistribution can increase total utility

[3] See Peter A. Diamond and James A. Mirrlees, "Optimal Taxation and Public Production: I and II," *American Economic Review* 61, no. 1 (March 1971): 8–27, and no. 3 (June 1971): 261–87, for a seminal work in the area of optimal taxation.

much. However, the goal of tax policy in this view is to create a more equal distribution of income, which can be contrasted with the goal of equality of opportunity. When economic analysis takes place within the context of maximizing a social welfare function, the conclusion is almost always that income should be redistributed (in addition to other possible policy conclusions) to maximize social welfare because the social welfare function approach directly weighs the well-being of all individuals against one another.

Utility Maximization of Those Least Well Off

John Rawls has argued for a policy that maximizes the well-being of those who are least well off in a society.[4] This policy not only strongly focuses on those who are at the bottom end of the society but also clearly recognizes the disincentives toward earning income that are inherent in any income redistribution scheme. Redistribution programs lower the whole society's income, so he suggests taxing high-income earners and redistributing the income to low-income people until the utility of the person with the lowest well-being is maximized. Without the disincentive effects involved in taxation and redistribution, this policy would lead to complete equality of income, but because of the disincentive effects, taxation of high-income earners would have to be low enough that the tax revenue raised on their incomes would not fall if rates were raised slightly. The relationship between this idea and the Laffer curve discussed in chapter 13 should be evident because both concepts recognize that tax rates can be high enough to lower the total amount of tax revenues raised and therefore reduce the total tax revenues available.

Government-enforced redistribution may be viewed as inequitable

Clearly, the idea that a more equal income distribution is desirable is normative, and one would expect some people to hold opposing views. Martin Ricketts, for example, has argued against a social policy that justifies the transfer of income from some people to others to enhance social welfare.[5] Ricketts observes that if income redistribution is justified in this way, then one is essentially condoning government policies that require some people to contribute to the incomes of others. Is it really fair to take a part of the income of some to enhance the income of others? One might object on equity grounds to government policies that redistribute income just because the government thinks that the utility loss to the losers is more than offset by the gain to the gainers. If your neighbor would gain more utility from owning your car than you would lose from not having the car, would that justify having the government take the car from you and give it to your neighbor?

In summary, some people argue in favor of governmental redistribution programs simply because they find equality of income to be a desirable end toward which government programs should work. This suggests that the tax system should be progressive enough to transfer income from rich people to poor people up to the point at which the cost resulting from the excess burden of the tax just offsets the benefit of a more equal distribution of income. In this view, taxes represent more than just a means

4 John Rawls, *A Theory of Justice.*

5 Martin Ricketts, "Tax Theory and Tax Policy," in *The Political Economy of Taxation,* ed. Alan T. Peacock and Francesco Forte (New York: St. Martin's Press, 1981), chapter 2.

to pay for publicly provided goods and services; they are also social tools by which greater equality in a society can be constructed.

There are two significant counterarguments to this viewpoint. One is that when some individuals are forced to give some of their income to others, those forced to give up their incomes are being unfairly coerced by the government. The other is that inequality often comes about because some people work harder and are more productive than others and therefore deserve the fruits of their labors. In this context, it is equality of opportunity—not equality of results—that is desirable. As previously noted, these are normative issues. Nevertheless, such issues can play a significant role in shaping public policy. Ultimately, it is the value judgments of voters and government officials that determine what the goals of social policy will be.

CHARITY AS A COLLECTIVE CONSUMPTION GOOD

The desire for a more equal distribution of income is only one of many possible justifications for the government to redistribute income. Another possible reason is that charity has some of the characteristics of a collective consumption good and so will be underprovided if left to the private sector of the economy.[6]

Charitable Giving as a Pareto Superior Move

Many people in society want to see those less fortunate than themselves helped out. That is the motive for charity. Charitable activity, which can increase the standard of living of less fortunate individuals, is a Pareto superior move because both givers and recipients are made better off. Note that to classify voluntary giving as a Pareto superior move is almost tautological. The givers must be made better off or they would not agree to give, and the recipients must be made better off or they would not agree to accept the charity.

The Incentive to Free Ride

Because potential givers want to see the well-being of the recipients enhanced, they also will receive increased utility from a knowledge of the charitable activities of others. This implies that charitable activity has some of the characteristics of a public good. Potential givers, in gaining utility from the knowledge that the recipients are being helped, have an incentive to become free riders. They would like for the well-being of less fortunate individuals to be improved, but they can free ride off the charitable activities of others.

The argument here is the same as with any other collective consumption good. Recall, for example, that national defense will be underprovided because people share

6 Harold M. Hochman and James D. Rogers, "Pareto Optimal Redistribution," *American Economic Review* 59, no. 4 (September 1969): 542–57, is an oft-cited article on this idea.

Potential donors may free-ride off the charitable activities of others

the same incentive to free ride on the protection produced by others, thus giving the rationale for the government to provide the good collectively. Likewise, with charity, people share the incentive to free ride on the charitable activity of others, which means that charity will be underprovided. The role of the government is to overcome the free rider problem by ensuring everyone's participation and providing the optimal amount of redistribution. By requiring those who are better off to give, everyone is made better off because potential givers are prevented from free riding on the charity of others and the optimal amount of charitable redistribution can take place.

In strictly logical terms, this argument for public sector production of charity is somewhat shaky. First, redistribution can hardly be considered to be Pareto superior because someone is sure to be made worse off by the redistribution. Could it be that not one of the millions of taxpayers financing the government's redistribution is worse off because of the programs? If even one person is made worse off, then we are back to the realm of interpersonal utility comparisons to justify the redistribution. Second, the result of the government's redistribution programs cannot be considered Pareto optimal. Because the actual demands for government redistribution programs cannot be measured, there is no way to know what the optimal amount is in the first place. Existing programs might be a move toward Pareto optimality, but they might not be. When people are coerced into participating, it is hard to determine the Pareto optimal outcome. Therefore, this argument about free riding on the charitable activities of others cannot be held as proof that the government should be involved in redistribution. On the other hand, the argument that free riding does occur in charitable activities is persuasive, so it is likely that charitable activity would be underprovided if left entirely to the private sector.

Redistribution as Insurance

Another possible reason to redistribute income through the public sector is that it acts as a type of income insurance. People with large incomes who pay taxes that go to redistribution programs are in effect paying a premium, and those with low incomes are receiving the payments. Note that this view of redistributive activities is compatible with the idea of the veil of ignorance discussed earlier. Behind the Rawlsian veil of ignorance—or even early in one's life—a person will not have a good idea about the amount of income one can expect to earn. Before the amount of income is known, a person might well agree not only to pay a larger-than-proportional amount in taxes if income is higher than average but also to receive income from high-income people if income is lower than average. In this sense, redistribution becomes a form of social insurance that partially protects people from having low incomes.

People might agree to be taxed in exchange for being eligible for benefits if they need them

This will be true not only among different people but also for the same person at various stages of the person's life. In a typical lifetime earnings profile, a person's income is relatively low when the person first begins work, but income rises as the person moves into middle age and then sinks after retirement to a lower level than existed in middle age. In applying the ability to pay principle over the course of the individual's lifetime, the person might choose to pay more in taxes when the taxes could be most easily afforded in exchange for being the recipient of redistribution during leaner years. The same might be true of individuals who are self-employed or who are paid mostly through commissions. Quite clearly, unemployment compensation falls into this category. Redistribution through the tax system acts as a sort of insurance plan by which premiums paid in the high-income years are exchanged for payments in the low-income years.

PROGRESSIVE TAXATION AND WAGE ADJUSTMENT

The progressive tax system can be viewed as a redistributive vehicle independent of redistributive expenditure programs, but market adjustments to the wage structure will at least partially offset the redistributive effects of progressive taxation. The reason for this is that workers ultimately work for after-tax income rather than before-tax income. If the tax system is made more progressive in an attempt to redistribute income, workers in higher-paying jobs receive less after-tax income and have an incentive to look for less demanding jobs, albeit at lower pay. Meanwhile, lower-paying jobs become more attractive because those jobs yield higher after-tax income, so the supply of laborers willing to take those jobs increases. The result is that for employers to retain their higher-paid employees, they have to pay them more to compensate them for the higher taxes the employees incur, but they can reduce the pretax wages of lower-paid workers because the more progressive taxation reduces the tax bill of those workers.[7]

Market wage adjustments will partially offset income redistribution through progressive taxation

This conclusion is an application of the concept of tax shifting that was explained in chapter 10. If the demand for labor in various occupations was completely inelastic, then any changes in the tax structure would be completely offset by changes in pretax wages, so increased progressivity would have no effect on the distribution of income at all. But some substitution of different types of labor (or capital for labor) is possible, so any change in the progressivity of the tax structure will be borne partially by workers, as the suppliers of labor. This is illustrated in figure 18.1, which shows the effect of an increase in progressivity on the wage of high-income workers, who will pay more in taxes.

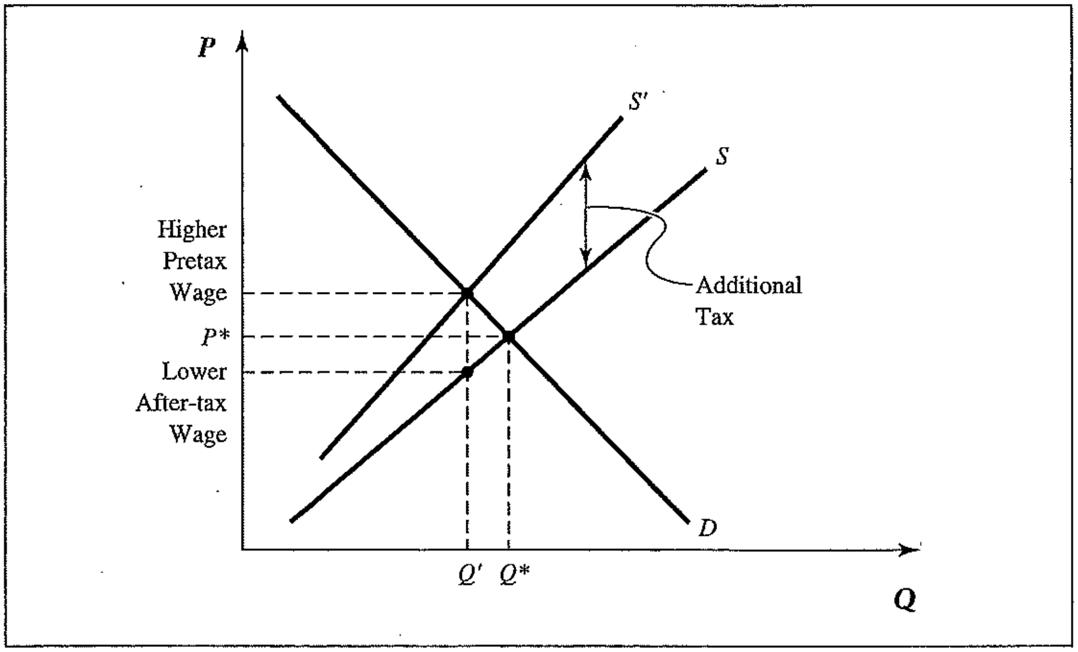
For high-income workers, more progressivity will mean that they will pay additional taxes. Before the change, the workers receive wage P*. As the suppliers of labor, when progressivity is increased, the supply curve for high-income workers shifts up by the amount of the additional tax, to S′. The pretax wage of the workers rises, as shown in the figure, while the after-tax wage falls. As was discussed in chapter 10, if the demand curve for labor were perfectly inelastic, the pretax wage would rise by the entire amount of the change in taxes.

The opposite would occur for low-income workers who would pay lower taxes under a more progressive system. If the diagram were drawn for these workers, the supply curve would shift downward to show a decline in income taxation, and the pretax wage of lower-income workers would fall. The net effect is that a more progressive tax structure raises the pretax income of high-income workers and lowers the pretax income of low-income workers to compensate them for the change in the tax structure, so

7 See Milton Friedman, *Price Theory* (Chicago: Aldine, 1976), 246–48, for an explanation of this idea.

■ **FIGURE 18.1**
WAGE ADJUSTMENT FROM AN INCREASE IN TAX PROGRESSIVITY

This figure shows the adjustment in wages for high-income workers when the tax structure is made more progressive. High-income workers are suppliers of labor and pay more in taxes as shown by the amount of additional tax. Before the tax change, the wage in this market would be P*, and the pretax wage rises as a result of the increase in progressivity, while the after-tax wage falls. The amount by which pretax wages adjust to offset increased progressivity depends on the elasticity of labor supply and demand.



progressive taxation is not as redistributive as at first it appears. Wages will adjust to partially offset any changes in the progressivity of the tax structure.

This means that one cannot measure the redistributive effects of progressive taxation simply by looking at the additional taxes paid by high-income individuals and the reduction in taxes paid by low-income individuals. The dollar amount of redistribution will be overestimated if this is done because a simple measurement of the amount transferred neglects to consider that through market forces, wages adjust to reduce the redistributive impact of progressive taxation.

DISTRIBUTIVE GOVERNMENT

Government redistribution has increased substantially since 1960

In the past several decades, an important change in the priorities of government programs in the United States has taken place. In 1960, government spending at all levels of government comprised about 28 percent of GNP, more than one-third of which went for national defense. In adding the revenues directed toward traditional areas of government spending, such as education and roads, we see a government dedicated to producing goods for collective consumption, with an emphasis on national defense. By 1980, government spending had risen to one-third of GNP, but less than one-sixth of total government spending was devoted to national defense. Rather, much of the additional spending in those two decades went toward redistributional programs.

By 1990, government spending at all levels of government had risen to 40 percent of GNP, and only 13.5 percent of total government spending was allocated to national defense, which continued the trends of the previous decades. From 1960 to 1990, the focus of government activity shifted from producing goods largely for collective consumption to collecting money from some people and transferring it to others.

This transformation has had a number of effects. One is that an increasing proportion of the population is dependent on government for a substantial portion of their incomes. Also, as the government's share of the economy has grown, this has increased the amount of money that the government redistributes, thus making it more worthwhile for special interests of all types to lobby the government for some type of special interest benefits. We discussed the role of special interests in government in chapter 9. Recall that special interests have an incentive to lobby for benefits from government, whereas the general public is rationally ignorant of most of what the government does. Thus, the government tends to produce special interest benefits rather than serving the general public interest.

The Incentive Structure of Government Programs

The intention here is not to condemn government activity but rather, by applying economic theory to political decision making, to show that the incentive structure of the government must be monitored carefully to ensure that government programs do what they are supposed to. When welfare programs were begun in the 1960s, for example, the intention was to help people to make a transition toward becoming a part of the productive economy, and those who initially advocated the programs envisioned that as the economy became wealthier, the number of people who would have to depend on the government for income would decline. However, welfare programs often provide incentives for recipients to remain out of work and in poverty. The goals of the programs were thwarted by the incentive structure they created.

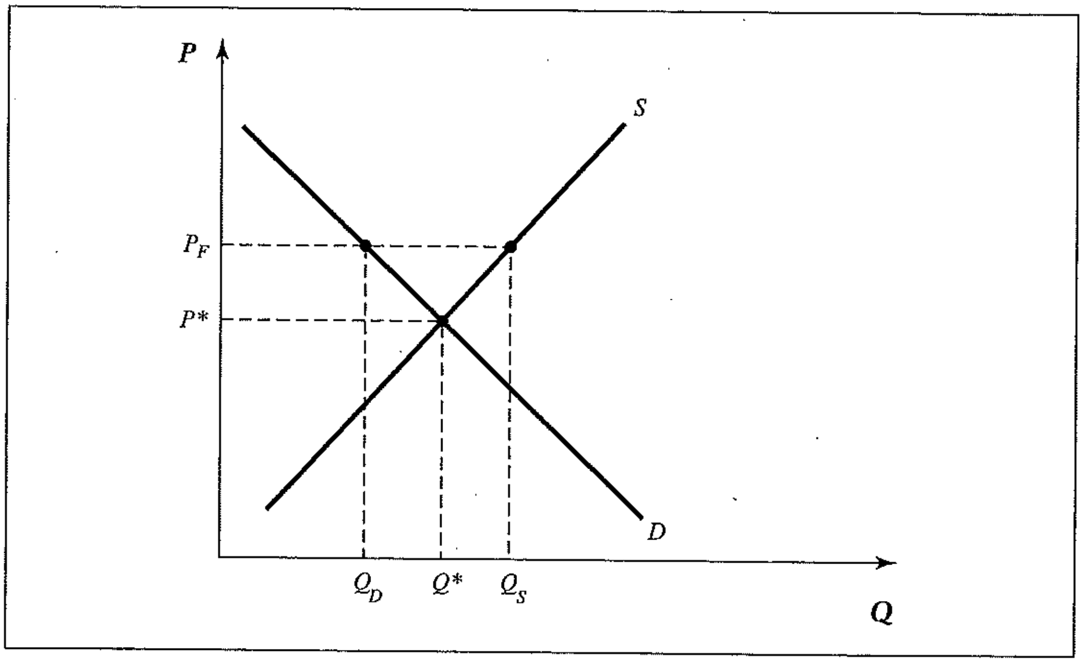
The incentive structure of government transfer programs can make people dependent on them

The incentive structure works similarly in programs other than poverty programs. Programs to help farmers have had the effect of making farmers dependent upon government subsidies for their survival. A good example is dairy price supports, although most any farm subsidy program would serve equally well. Figure 18.2 depicts a price floor that holds the price of dairy products above the market equilibrium price. P* is the price that would exist in the market without the government program, and Q* is the amount that would be sold. The government price support, by holding the price at a higher level, P_F, causes the quantity demanded to fall to Q_D and the quantity supplied to rise to Q_S.

Because of the price support, consumers consume less while producers produce more, thus creating a surplus. Because of the higher price, producers have an incentive to produce more output and even more profits, but this in turn bids up the value of the resources used in producing dairy products. For example, the price of farmland will be higher because farmland helps farmers obtain government payments. The expected present value of future government payments will be capitalized into the value of the land. Ultimately, the higher profits initially created by the price supports will be competed away and farmers make only normal profits when producing quantity Q_S at price P_F. The result is that dairy farmers become dependent on the subsidies to stay in business. The establishment of a program creates a transitional, or temporary,

FIGURE 18.2
A PRICE FLOOR

By holding the price up at P_F, a price floor redistributes income from buyers to seller of a product. Above-normal profits can be earned temporarily, but, eventually, the price of inputs in the market will be bid up to reflect the value of the product's higher price, and producers eventually will earn only a normal rate of return.



gain to the recipients, but after the transitional gain, there are only normal returns to be earned. But abolishing the programs would result in transitional losses to those who are dependent on the programs.[8]

REDISTRIBUTIVE PROGRAMS AND THE POOR

On the surface, it would seem that if government programs provide income and in-kind benefits to the poor, the well-being of the poor should increase. Considering the issue in more detail, however, there are a number of reasons why this may not be the case. The incentives fostered by most transfer programs encourage recipients to earn less income on their own. This can reduce the income of the poor in the short run, and it can make it more difficult in the long run to escape poverty.

Incentives to Earn Less Income

Programs that redistribute income to low-income individuals in effect make payments in exchange for being poor. As long as the recipient remains in poverty, the payments

8 See Gordon Tullock, "The Transitional Gains Trap," *Bell Journal of Economics* 6 (Autumn 1975): 671–78.

continue, but if the recipient escapes poverty, the payments stop. Although welfare recipients might be able to make more monetary income by working, nonmonetary benefits such as low-income housing and government-provided health care can make welfare look attractive when compared with a low-paying job. When one factors in child care expenses for welfare recipients who are parents, and the costs of transportation to work, uniforms, and other possible expenditures, it is not hard to see why it would be difficult to give up the entitlements provided by the welfare system in exchange for an entry-level job.[9]

As was discussed in chapter 13, high marginal income tax rates discourage the earning of income. Although we normally associate high rates with high-income individuals, the income tax rate for welfare recipients is higher than for anyone else in the economy if we include not only the taxes they pay but also the benefits they lose. People who give up welfare in exchange for low-paying jobs will see little if any improvement in their standards of living, but they will have to work for the money. With these disincentives, it is no mystery why people can remain on welfare for long periods. This is not to suggest that people would rather be on welfare than work for a living, but rather that the incentive structure encourages people to remain on welfare and not take low-paying work.

The result is that welfare programs may create poverty by creating a permanent class of welfare recipients. In 1950, when the first reliable statistics on poverty in the United States were available, about 35 percent of Americans were living below the poverty line. That percentage declined consistently to about 13 percent by 1968, four years after President Johnson announced the War on Poverty Since then, the poverty rate has remained nearly constant at about 13 percent. It is interesting to note the steady decline in poverty before the War on Poverty and the stabilization in the poverty rate since then. Have poverty programs had any impact?

The poverty rate has not declined since the war on poverty was declared in the 1960s

One must be careful about relying too heavily on the official poverty figures because much income is likely to be left out. Income in kind, such as Medicaid benefits and subsidized housing, is not included as income, nor is income from the underground economy. Welfare recipients have an incentive to work odd jobs for cash without reporting their income in order to retain welfare benefits. If these types of unreported income were included, it might be that the poverty rate is lower than the official statistics indicate.

One area in which poverty programs probably have had an impact is on the stability of family units. Programs like Aid to Families with Dependent Children are targeted to households headed by single mothers, creating an incentive for single mothers to remain unmarried. If a single mother is contemplating getting married to someone with a job, she will likely lose all her welfare benefits. Financially, the two would be better off unmarried so they can share his income and her entitlements. In 1965, 11.6 percent of families with children under eighteen were headed by single parents. That number had jumped to 27.3 percent by 1991.

9 Some statistics of the benefits welfare recipients can receive are given in James Gwartney and Thomas S. McCaleb, "Have Anti-Poverty Programs Increased Poverty?" *Cato Journal* 5, no. 1 (Spring/Summer 1985): 1–16.

The Hard-Core Poor and the Marginal Poor

There is an important distinction to be made between the hard-core poor and the marginal poor.[10] The hard-core poor are individuals who are poor because of injuries, disease, or some other type of disability and who have little control over their incomes. By contrast, the marginal poor are poor because of things such as a lack of education, pregnancy, change in family status, or a general economic downturn. Although these individuals may be the victims of misfortune, they are in a position to improve their economic status and move out of poverty on their own. Workers can find jobs when the economy recovers, mothers of young children can reenter the labor force, and individuals can get additional education or on-the-job training if the incentives for them to do so are strong enough.

A major goal of redistribution programs is to help the hard-core poor, who realistically cannot support themselves. But, in the process, redistribution programs provide incentives to the marginal poor to remain in poverty to qualify for government programs. When individuals can earn nearly as much money remaining unemployed as reentering the labor force, there is little incentive for them to work. Eventually, the marginal poor who are unemployed become unemployable and join the ranks of the hard-core poor.

Growing Dependency on Government Programs

The term applied to the marginal poor who gradually become the hard-core poor is welfare dependency, and, considering the incentives built into the redistribution system, it is easy to see how this process takes place. For an individual with low skills, one way to develop skills is on-the-job training. For example, an individual can take a job in a garage, at minimum wage, and learn automobile maintenance through training on the job, gradually increasing skill levels until a higher wage can be earned. Of course, on-the-job training can only take place if the person has a job in the first place, and redistribution programs that pay a person as much for being unemployed as for working at a low-skill job provide little incentive to get that first job through which valuable job skills could be obtained. The result is that the person who could have been on an upward-earning track out of poverty remains poor and dependent on government programs for income.

Welfare programs may sometimes be responsible for keeping people in poverty

Another problem with redistribution programs is that often to qualify, the recipient must be unable to work. For example, a single mother with children at home would be considered unable to work, so she has an incentive to continue having children to continue her entitlement. Two-parent families have an incentive to split up so they can qualify, which is especially hard on the children and can lead to a new generation of people dependent on government transfers. Following this line of reasoning, redistribution programs have actually harmed the marginal poor by making it harder for them to escape the conditions of poverty.[11]

[10] This distinction is made by Gwartney and McCaleb, "Have Anti-Poverty Programs Increased Poverty?"

[11] See Charles Murray, *Losing Ground* (New York: Basic Books, 1984), for an extended treatment of this theme.

This is the line of reasoning that led President Clinton, during his campaign in 1992, to promise to end welfare as we know it. Government programs undoubtedly help the hard-core poor, and they may provide some transitory assistance to the marginal poor. Nevertheless, we must recognize that redistribution programs contain incentives to remain poor if that is what it takes to qualify. Thus, to design the most effective redistribution programs, we need to provide incentives to escape poverty rather than to become dependent on a continuing flow of entitlements from the government.[12]

THE POLITICS OF REDISTRIBUTION

The political environment within which redistribution takes place ultimately determines the types of redistribution programs that will be crated. Before 1972, national defense was a larger share of federal government spending than were transfer programs, but, by 1972, each accounted for 32 percent of federal spending. Since 1972, transfer payments have exceeded defense expenditures. As the government spends increasing amounts on transfers, special interests have an increased incentive to lobby for transfer payments. It also creates a substantial transfer ''industry'' of individuals—often, but not necessarily, working for government—who make their livelihood from the redistributive programs of government and thus have an incentive to perpetuate those programs. However, the incentives facing government administrators are not always completely in line with the welfare of those who receive the transfers.

As transfer programs become a larger share of government spending, there is more to gain from trying to get a share

There are two main points to consider here. First, as redistributive programs become a larger portion of the government's budget, special interests have increased incentives to lobby for redistributional benefits. With more money to be redistributed, the potential payout is greater. Second, the establishment of redistributive programs creates a welfare industry made up of people who administer government programs and people who benefit from the programs (such as owners of low-income housing, who receive much of their rent from government housing subsidies). This welfare industry wields political power that is an important force in perpetuating and expanding its programs. Therefore, to completely understand the government's redistributive programs, we must not only recognize the positive consequences of the programs and the normative equity issues involved but also consider the political environment in which the policies are created and perpetuated.

Incentives of Administrators

The theory of bureaucracy discussed in chapter 9 suggests that bureaucrats have an incentive to maximize the budgets of their bureaus, and the same principle applies to bureaus that are engaged in redistribution. But increased spending is not easily correlated with increased well-being of groups targeted for help. Thomas Sowell has studied the effects of government programs designed to help the disadvantaged and

12 For further discussion on reform designed to make welfare recipients self-supporting, see Mary Jo Bane and David T. Ellwood, *Welfare Realities: From Rhetoric to Reform* (Cambridge, Mass.: Harvard University Press, 1994), especially chapter 1.

noted, "It would be easier to find an *inverse* correlation between political activity and economic success than a direct correlation."[13] Sowell clearly believes that government programs have, on net, hurt Blacks, despite the fact that their stated goals are often to help minorities.

Sowell does not view these negative effects as the result of well-meaning individuals who have somehow steered government programs in the wrong direction but rather as the result of the rational self-interests of government administrators and Black leaders to maintain the system that provides their livelihood. Sowell argues, "However catastrophic the politicization of race may be in the long run, from the point of view of individual leaders, it is a highly successful way to rise from obscurity to prominence and power. . . . In short, despite the unpromising record of politics as a means of raising a group from poverty to affluence, and despite the dangers of politicizing race, there are built-in incentives for political leaders to do just that."[14]

Political incentives may produce programs that benefit administrators but harm recipients

Walter Williams is another economist who has argued that government policies have, on net, harmed minorities.[15] How should these arguments be evaluated for purposes of public policy? Above all, these arguments indicate that the political process can be better understood by looking at the economic incentives of participants in the process. Certainly, some individuals may profit from the expansion of redistributive programs, regardless of whether the poor benefit. This does not imply that we should do away with all such programs but rather that we need to examine carefully the incentives of both the recipients and the administrators.

The government cannot solve problems simply by spending money on them, and money spent on redistributive programs can be spent foolishly, just as with any other type of government expenditure. Wasteful spending at the Pentagon, though perhaps more newsworthy, derives from the same incentives for mismanagement of funds and ineffective programs that face redistributive programs. It is not enough to simply look at the number of dollars being spent to see what the government is doing to assist underprivileged individuals. In redistributive programs, as in all government spending, the political incentives can often cause ineffective programs to be favored over potentially effective ones.

The Goals of Redistribution

The government collects a substantial amount of money from some people to redistribute to others. In 1990, total social welfare expenditures by all levels of government were 19.1 percent of GDP. These expenditures include social insurance, public aid, health and medical programs, housing, education, veterans programs, and a small amount of other programs. One might want to view veterans programs as associated with military spending, and education as not directly redistributive, but even subtracting veterans programs and education leaves 14.5 percent of GDP as programs that have redistribution as their primary goal. Keep in mind that educational expenditures such as scholarships and subsidized school loans are clearly redistributive. This 14.5 percent of GDP also does not include agricultural programs that subsidize the incomes of

13 Thomas Sowell, *Civil Rights: Rhetoric or Reality?* (New York: Morrow, 1984), 32.
14 Sowell, *Civil Rights*, 35.
15 Walter E. Williams, *The State against Blacks* (New York: McGraw-Hill, 1982).

farmers or any other programs that are intended to increase the incomes of people in particular industries.

With a GDP of $5.22 trillion in 1990, the 14.5 percent of GDP going directly to redistribution was $757.2 billion. The 1990 U.S. population was 250 million, so each person's share of that expenditure was $3,029, or, for the typical family of four, $12,116. These programs are not cheap. Assume that we decide that the bottom 20 percent of Americans by income are deserving of government redistribution. If only those bottom 20 percent shared in the government's redistributive expenditures, that would be 50 million people over which to divide the $757.2 billion, which would give each person $15,144. If we just took the money that government redistributes and gave it to the neediest 20 percent, a needy family of four would have received $60,576 in 1990, which would have been enough to make the needy very comfortable. We are spending enough on redistribution to substantially improve the well-being of those in need, yet the needy are not doing nearly as well as these figures would suggest they should. Why not?

The government spends more than 14 percent of GDP on redistribution

The main reason is that much of the income redistribution that the government does is not from rich to poor but from those with middle incomes to those with middle incomes. Most tax revenues are raised from middle-income people because they earn the bulk of the income, and many transfer expenditures, such as Social Security, go to people who would be able to take care of themselves in the absence of the transfer. A contributing factor is that many redistribution programs do not just take income from some to give to others; they have overheard expenditures (government workers must be paid), and they transfer income in kind, such as government-produced housing and health care, that may not have as much value to the recipient as the cost to the government.

Benefits to the needy are limited because much redistribution goes to those who are not poor

What lessons can be drawn from these calculations? First, much redistribution is not targeted specifically to the needy. Considered in the political context within which redistributive decisions are made, this should not be surprising. Poor people, who do not have many resources, will not be able to devote much to lobbying the government for benefits, while other groups are better organized and better funded and can exert political pressure for transfers. The most visible citizens in this regard are the elderly, who work diligently to protect and enhance their government transfers. Social Security is such a significant transfer program that chapter 20 is devoted exclusively to it.

A second lesson is that if tax revenue were distributed directly to poor people, poverty could, at least theoretically, be eliminated. In 1990, a family of four would have received more than $60,000 in benefits if government transfer payments were equally divided among only the bottom 20 percent of citizens by income. Despite this massive redistribution effort, poverty remains. This is partly because government redistribution programs are subject to pressure from interest groups and are designed through political pressure rather than according to some abstract notions of the public interest. The welfare industry itself has an incentive to perpetuate the poverty that creates a demand for its services. Thus, there are several reasons why the taxes paid for redistribution are less effective than they could be at alleviating the problems of poverty.

The government redistributes enough money to eliminate poverty

CONCLUSION

Redistribution is an important area of public finance because it is one of the major activities that governments engage in. Redistribution also encompasses a number of difficult issues. Not only is it based on normative foundations that are sometimes not clearly understood, but also programs, once established, can have consequences very different from their stated intentions.

There are many possible motivations for establishing redistributive programs in government. The most obvious is a simple desire to help those in need. Another motivation is to see more income equality in the nation. One might also argue that the social welfare would be increased by transferring income from those who are better off to those who are worse off. This argument requires some interpersonal utility comparisons to be made because the effects of such transfers will make some people better off but others worse off. There is a clear difference between desiring redistribution to help those in poverty versus trying to make the income distribution more equal, but often this distinction is not clearly made, so the different goals of promoting equality and alleviating poverty can become confounded in policy discussions.

Government involvement in redistribution can be justified on a number of grounds. Charitable activities share some of the characteristics of public goods, and individuals have an incentive to free ride off the charitable contributions of others. Because everyone has the same incentives, charitable activities would tend to be underproduced if left solely to the market. Thus, government might play a role by collecting taxes to finance the optimal amount of charity. Redistribution programs also might be viewed as a type of insurance, by which payments are made to lower-income individuals from premiums paid by higher-income individuals. Clearly, some redistributive programs, such as unemployment compensation, are of this type.

Many different motivations contribute to the demand for redistributive programs. In addition to the demands of the recipients and taxpayers, there is a substantial industry that is supported by redistributive programs. Program administrators and others who receive income from the programs exert influence through the political system and help determine the characteristics of the nation's redistributive programs.

The results of redistribution programs are often different from what was initially intended, with the result that in the 1990s, no one is really happy with the system, including the recipients. Payments to poor people often give them little incentive to escape poverty, creating a cycle of welfare dependency that can go on for generations. Designing programs to help those who are needy without giving people an incentive to become needy is a challenge. Economic analysis can often clarify the incentives implied in programs as well as help to predict and explain some of the effects of government programs. Chapter 19 takes a more analytical look at the structure of redistributional programs.

QUESTIONS FOR REVIEW AND DISCUSSION

1. Discuss the differences between policies to help the poor and policies to create more income equality. Are they the same thing? How would you rank the relative importance of these goals? Explain.
2. Government redistribution programs in the United States focus mainly on those within U.S. borders, even though the poor in other nations are much worse off than the poor in the United States. Is it appropriate for redistributive programs

to favor those within a nation's borders, or should those less fortunate individuals in other nations be given equal consideration? Defend the value judgments you make to frame your answer.

3. What characteristics might an equitable tax structure have? Differentiate between the concept of equity implied in the fiscal exchange model of taxation and one that uses the tax system as a tool to redistribute income.
4. Explain the distinction between equality of opportunity and equality of results. Which is more appropriate as a goal of social policy? Can both be incorporated into the same public policy? Explain the circumstances under which they might be applied.
5. Explain why the market might provide less than the Pareto optimal amount of income redistribution. Is this an argument for using tax revenues as a source of income to redistribute? Explain both sides of the argument. Which side do you think is correct?
6. Almost all religious institutions in the United States (churches, synagogues, temples, etc.) receive their income from voluntary contributions from those attending. Is there a potential free rider problem with these institutions that might cause donors to contribute less than the optimal amount? If not, why would funding for these institutions be optimal, considering the potential free rider problem that justifies government involvement in redistribution? If so, do you think that the government should become involved in funding religious organizations to help overcome this free rider problem?
7. Normative questions, unlike positive ones, do not have a single right answer. If this is so, why are normative questions so important to issues such as redistribution? Why can these issues not be resolved solely in terms of positive analysis?
8. Explain why a progressive tax system has less of a distributive impact than the amount of money taken from some people and given to others would suggest. What are the implications for the use of progressive taxation as a redistributive tool?
9. Explain the distinction between the hard-core poor and the marginal poor. Should public policies for these two groups be designed differently? If so, how would you go about identifying who belonged to each group, and how would you design programs to best help each group?
10. Explain the concept of welfare dependency. Why can people become dependent on government programs for their support?
11. Discuss the political environment within which redistribution programs are created. What role do special interests play in the process? The cost of governmental redistribution programs is substantial, yet the poor are still not very well off. Could the political environment be partially responsible? Discuss and explain.