Chapter 4-- Reversing Robin Hood: How To Transfer Income to the Non-poor

As noted earlier, a vast array of government policies redistribute income to the non-poor in a variety of product and labor markets. Presumably, these efforts are not designed to hurt the poor; their harm is merely a by-product or an indirect effect of policies with other goals. Regardless of the intentions, the results hammer the poor all too often.

Political vs. Economic Markets

"Public Choice" economics (a term I will use often) deals with the marriage of political science and economics-- the idea that people behave in self-interested ways in political markets as well as economic markets. In other words, agents in political markets (elected officials, bureaucrats and their constituents) make their decisions by implicitly weighing the benefits and costs of the available alternatives. Instead of merely viewing government officials as benevolent public servants, we understand they are also interested in enhancing their careers and increasing their incomes.

To some, this may seem like old news. But our current perspective comes after 30 years of growing cynicism with the people who represent us, the promises which are constantly broken, and the failed policies which emanate from all levels of government. When James Buchanan and Gordon Tullock developed Public Choice theory in the early 1960s, it was a novel approach.[1] Subsequently, Buchanan was awarded the Nobel Prize for Economics in 1986.

Political markets are fundamentally different from economic markets in a number of ways. Generalizing each: political market transactions involve C taking money from A to give to B; economic market transactions involve A giving money to B in exchange for goods or services. What are the differences?

First, political markets are coercive-- money is forcibly taken from A. Economic markets are voluntary-- A willingly gives his money to B. Second, political markets make two parties better off (C and B) at the expense of somebody else (A). Economic markets feature "mutually beneficial trade"-- both parties (A and B) perceive they will be better off. In the absence of coercion and fraud, both parties enter an economic arrangement expecting to benefit. Third, political markets merely move wealth around, transferring money from one party to another; economic markets create wealth since both parties benefit from the trade. The former is a "zero-sum game"-- A loses \$5, B gains \$5; the sum is \$0. In contrast, economic activity is "positive-sum." Fourth, political markets involve a third party-- the "middleman" (C)-- who must be paid a salary. Further, it is highly unlikely that C will spend A's money as well as A would have spent it. These are two reasons why governments and their bureaucracies are more inefficient than economic markets. Fifth, in economic markets, self-interest gives producers an incentive to please their customers. In the "selfish" pursuit of greater income, producers inadvertently benefit others. In political markets, self-interested "producers" have an incentive to develop more sophisticated ways to take money from A to give to B.

Finally, governments and bureaucracies tend to be inefficient because they are typically motivated to maximize their budgets rather than maximizing profits and minimizing costs. The primary incentive for a government agency is to exhaust its yearly budget so it can return to the legislature and request additional funds the next year. If bureaucrats fail to spend their funds, it is likely they will have a smaller budget in the subsequent year. Anyone who has been involved with government enterprises knows stories about "trying to spend all the money."

In sum, although individuals exhibit self-interested behavior in both economic and political markets, the results are vastly different.

The Politics of Redistribution

In Welfare for the Well-to-do (1983), Tullock argues that the bulk of government's redistributive efforts go to "the organized"-- commonly known as "special interest groups."[2] These groups are primarily, although not exclusively, members of the middle class. They encourage government to intervene and redistribute income away from the general public through higher taxation or higher prices. How does this work and why do people tolerate it?

Let's establish a hypothetical government program where \$260 million is taken from

260 million citizens through taxes to give to 10,000 people. The cost to each person would be a dollar; the benefit to each recipient would be $26,000.

First, think about those paying for the program-- the general public. A dollar each for a family of four amounts to four dollars per year or $.33 per month. Who would notice such a minor expense? Now imagine that instead, the four dollars are extracted through slightly higher prices for some good bought throughout the year. Who would attribute the higher prices to the government program? These costs would be extremely subtle. Further, even if one did notice the additional cost, who would get excited about losing four dollars? Who would devote time and energy to defeat the government program? Only the most indignant would bother. In these matters, the public is usually "rationally ignorant"-- ignorant because they typically fail to see the small and subtle costs imposed upon them, and rationally so, because individually these small costs are simply not worth the time and effort to pursue their removal.

Now, consider those receiving the transfer-- the "interest group." As opposed to the apathetic general public, this group will be very excited. There is probably no other public policy issue which they will care about more. They have an incentive to pursue this program with great time and energy. They have an incentive to be selective with or to twist information in any public debate. They have an incentive to create compelling stories for why the redistribution should occur-- why it is good for the country or the general public, etc. They have an incentive to support those in government who make the transfer possible-- through a block of votes, campaign contributions of time and money, or even bribes. This amounts to mutually beneficial trade between government officials and the special interest group-- at the expense of the general public.[3]

In sum, there is a small group receiving benefits which are large and easy-to-see (at least for them). There is another small group which facilitates the transfers-- politicians and bureaucrats administering the program-- who benefit as well. And there is a large group whose members absorb relatively small and difficult-to-see costs. The latter group hardly notices the loss while the first two groups pursue such intervention with great vigor and passion. A similar explanation is that people have a greater interest in the relatively few things they sell (their income) as opposed to the innumerable things they buy.

Politics Continued: "How Do We Sell This?"

Imagine you are the public relations representative for one of these special interest groups. Here's what you cannot say to the public: "we want the government to increase your product prices (or taxes) because we want higher incomes." People would find this rationale outrageous. So how do you sell the policy to the general public and get them to accept and even enjoy you reaching into their wallets?

Many rationales will be discussed in the next few chapters. Probably the two most popular general reasons are spoken concerns for the best interests of consumers and appeals to nationalism or other emotions. The former consists of supposed concerns about the safety or quality of a good or service, the desire for stable prices, etc. Ironically, one rarely hears consumers testifying about the need for such intervention. Almost always, it is incumbent firms seeking protection from outside competition who speak on behalf of such proposals. For example, occupational licensing restrictions are usually sought by the existing firms/practitioners in a given market. Further, any new requirements are usually "grandfathered"-- incumbents are immune to the new restrictions. If the well-being of consumers was the primary motivation, presumably all suppliers would have to measure up to the new standards.

Appeals to emotion are also popular. Through the years, we have heard about "saving the family farm," the need to provide a "living wage" (a higher minimum wage) and a "giant sucking sound" (supposedly how "free trade with Mexico will cause all of our jobs to go south of the border"). Independent of any merit in their arguments, such ploys are primarily based in rhetoric.

Frequently, the arguments contain a kernel of truth but are only correct to a limited extent or tell only part of the story. Remember-- you do not need a very sophisticated rationale to sell the policy. With a rationally ignorant public, a story which sounds good on the surface will usually carry the day. Likewise, their arguments lack objectivity by definition. Would you expect to get objective opinions about chiropractors from orthopedists? Do you blindly accept negative remarks about companies from their rivals? Firms always have an incentive to denigrate and/or restrict their competition.

Finally, proponents of government activism always have an incentive to only tell you about the best parts of their proposals. By nature, those who support a program will tell the public about the benefits of the policy while ignoring or downplaying its costs. Similarly, when two people run for political office, each one has an incentive to talk about the benefits of their policies and the costs of their opponent's proposals. Further, politicians have an incentive to make the costs as indirect and "long run" as possible-- to make the costs more difficult to see.

James Schlesinger aptly describes the goal of the game: "to extract resources from the general taxpayer with minimum offense and to distribute the proceeds among innumerable claimants in such a way to maximize support at the polls. Politics...represents the art of calculated cheating-- or more precisely, how to cheat without being caught."[4]

Hazlitt's "Lesson"

Henry Hazlitt's Economics in One Lesson is a one-of-a-kind book. Written in 1946, Hazlitt hoped to dispel the myths behind Keynesian economics and activist government policy.[5] Almost half a century later, the battle against economic ignorance still continues. In Hazlitt's words, the "lesson" is that "economics consists in looking not merely at the immediate but at the longer effects of any act or policy; it consists in tracing the consequences of that policy not merely for one group but for all groups."[6] In other words, economics is a way of thinking-- it is an intellectual discipline to look for all the benefits and costs of a given policy.

Let's start with a basic proposition-- the familiar dictum: "there's no such thing as a free lunch." Everything government spends must be paid for through some type of taxation-- higher current taxes, higher future taxes (deficit spending and debt) and/or inflation taxes (printing money to pay bills, making current money worth less).

Of course, government will often choose to defer costs into the future (deficit financing) or to make them less visible (print more money; inflation). But to simplify things, assume that government programs are paid for with current taxes. Our $260 million program from the last section will create 10,000 jobs. Meanwhile, government has taken $260 million away from taxpayers that would have been used for consumption or saving. If spent, it would have created jobs in many different industries-- appliances, dry cleaning, movie rentals, etc. If saved, it would have been used to invest in capital and spur economic growth. At best, government's activism would amount to a "shell game": government would create $260 million worth of jobs in the public sector (or subsidized by government) while destroying $260 million worth of jobs in the private sector. (Often, proponents of government programs will argue that those with the created jobs will spend their money, creating more jobs, etc. Of course, the same reasoning holds for the jobs destroyed by taxing the public to pay for the programs. This returns us to the "shell game" idea.)

Given that the newly created jobs are subsidized or in the public sector, government will almost certainly destroy more than it will create. As we noted earlier, political markets and bureaucracies are not known for their efficiency. An extreme case would be to pay people to dig holes and fill them up again. Jobs will be created, but nothing useful will have been produced by these "make work" jobs. Meanwhile, the private sector suffers. The bottom line is that (with a few exceptions) government cannot create "net" jobs; it can create jobs through spending programs, but will destroy more through the subsequent taxation.[7] We will revisit failures to understand Hazlitt's lesson throughout the book.

As Dave Barry notes sarcastically: "when the government spends money, it creates jobs; whereas when the money is left in the hands of taxpayers, God only knows what they do with it. Bake it into pies, probably. Anything to avoid creating jobs." Taking money from the general public will create jobs, but it will destroy jobs taxpayers would have created on their own.

Why are these policies so popular? Return to the tenets of Public Choice economics.

The jobs that are created are relatively obvious. (If the jobs are in construction, they even wear orange vests to help you see them.) The jobs that are destroyed are quite difficult to see. They are eliminated one dollar at a time (the amount taken from each citizen) and in many different industries. Who would attribute a particular job loss to the tax increase?[8]

Hazlitt also acknowledges the importance of interest groups in the political economy of a democracy. He opens his text with the idea that "economics is haunted by more fallacies than any other study known to man. This is no accident. The inherent difficulties of the subject would be great enough in any case, but they are multiplied a thousandfold by a factor that is insignificant in say, physics, mathematics or medicine-- the special pleading of selfish interests."[9] The incentive to twist or omit information is not nearly as prevalent in other fields. And when information is distorted in these other fields, it is often done in the pursuit of government (political market) grants. Self-interested groups have an incentive to take advantage of the "rationally ignorant" public through political markets.

Government can redistribute income in a variety of ways. Direct redistribution to the non-poor would not be politically popular. So most of the time, politicians use indirect methods to transfer income to special interest groups. The indirect method involves restricting competition.

There is <u>Always</u> an Incentive to Restrict Competition

The story begins with the desire of a firm to charge higher prices and obtain greater profits. But since most markets are rather competitive, a firm's efforts to increase its price are frustrated by other firms undercutting their price and taking their customers. As a result, firms often look to restrict their competition by forming voluntary associations which restrict output, allowing incumbent firms in the industry to charge a higher price. The firms want to collude and behave as a monopoly. These are frequently called "cartels."

Thus, there is always an incentive to collude. But unfortunately for a fledgling cartel, once the firms have colluded to restrict output and increase prices, there is also an incentive to cheat on the cooperative agreement. It is now in each firm's best interests to produce and sell a few more units since those would be very profitable-- units for which the market price significantly exceeds the costs of production. In addition, outsiders also see a profitable opportunity and may decide to enter the market. If some of the firms cheat or if challengers enter, then we return to the competitive outcome we had before; the attempt to increase prices and profits will be thwarted.

This is why so few voluntary cartels work. In recent times, only OPEC's control over oil and DeBeer's monopoly power over diamonds have been at all successful.[10] Usually, the cartel is unable to monitor and enforce the agreement properly. If cheaters cannot be inexpensively policed, the agreement will fall apart.

Because they are unable to collude on a voluntary basis, frustrated industries then turn to government because it has the coercive power necessary to enforce such agreements. In the words of Walter Williams, "free market competition is the most stringent, unyielding form of regulation there can be. That's precisely why so many sellers fear and abhor the free market...their common desire is to use government to lock out potential competitors-- whether by import tariffs, minimum wages or airline regulation."[11] The use of government to restrict competition will be a prevalent theme in subsequent chapters.

Two Examples

The next few chapters will be replete with examples of the concepts explained in this chapter-- Public Choice economics and Hazlitt's "lesson." However, before we continue, I want to illustrate these principles by thoroughly describing a "direct" example-- a minimum wage for college professors, and an "indirect" example-- sugar price supports.

My university has considered passing a minimum wage for its faculty. For those currently below the proposed minimum, the market has determined a value for their services, but the political process has decided that these salaries are "too low." (As with any other "sellers," they would like their prices to be higher.) For teaching three or four courses in the Fall and Spring semesters and doing some service and research, all assistant professors would make at least $29,000; all associate professors would make at least

$36,000; and all full professors would make at least $43,000. Note that all of the professors would then have incomes greater than the median household income level for the population. Assuming the money comes from expanding the university's budget, this policy amounts to redistribution from the taxpayers of Indiana to people in an upper-income class.[12]

Political markets have determined that we should protect our sugar farmers from foreign competition. The preferred tools are price supports and an import quota to prevent foreign suppliers from entering the market and creating a surplus. The resulting domestic price of sugar often doubles the world price. As always, domestic producers benefit from the restricted competition. And as always, consumers are hurt by having to pay higher prices. The poor are hammered especially hard because a higher proportion of their budgets are used for food. But how much are consumers hurt by an artificially high price for sugar? How many bags of sugar does the average family buy in a year? Not many. So why is this important? The much more significant cost is that any product which contains sugar as an input will also be more expensive (soft drinks, fruit juices, cereal, etc.). So, people get "nickel-and-dimed" to death at the grocery store through higher product prices-- $50 per year for the average family of four and $3.2 billion for the entire country.[13] Jobs are destroyed because consumers have less disposable income.

Moreover, firms which use sugar (especially candy companies) are placed at a competitive disadvantage with foreign companies who have access to low-cost foreign sugar. A few years ago, citing higher sugar prices, Brach's Candy closed a plant in inner city Chicago and moved overseas. Many other jobs in industries which use sugar have been lost as well. And what about foreign producers? Producers from countries like Haiti are told they cannot sell their goods in our markets. It is less than friendly to turn away producers from a country with an average income of $300 per year.

What about the politics of this redistribution? Its subtlety is a work of art. Who knows they pay more for a six-pack of soda because of sugar price supports? Who knows why jobs are lost in firms which use sugar as an input? While the costs are diffuse and extremely difficult to see, apparently the beneficiaries know what they are getting. The average sugar cane plantation received $235,000 in 1991. In response, interest groups for sugar farmers spent $1.7 million in 1990 defending their subsidy in the farm bill.[14] Even corn producers contributed to politicians since their corn syrup (as a substitute) benefitted from the restriction in competition as well.

Why Does This Happen?

After people understand these principles and see a few examples, they want to know if these things are done out of ignorance or deceit. Certainly, there are numerous examples of both, but it doesn't matter much; the results are still the same. The goal of these redistributive efforts is certainly not to hurt the poor, but self-interest outweighs any knowledge that the poor are harmed.

Given that the bulk of redistributive efforts go to "the organized," we give lip service and a few programs to the poor, but the big dollars go to special interest groups. The problem for the poor is that once you rationalize the use of government to redistribute income, the poor may be harmed overall, since they do not organize as effectively.[15]

The principles developed here are responsible for the bulk of all government policy. They explain why policies exist when most would agree the costs outweigh the benefits, when the number of "losers" far exceeds the number of "winners." The key is that the costs of the policy are small, diffuse and very difficult-to-see. They also explain why children do so poorly and the elderly do so well in the redistributive game: the former cannot organize directly while the latter group can. Finally, it holds the key for implementing reform: making the difficult-to-see costs easy to see. In any given case, once the general public realizes its income is being transferred to those with above-average incomes, reform is inevitable.

Notes

1. Their seminal work was The Calculus of Consent (Ann Arbor, MI: University of Michigan Press, 1962).

2. See also: R. Wagner, To Promote the General Welfare, San Francisco: Pacific Research Institute, 1989.

3. This also explains why politicians receive campaign contributions even when they are unopposed in an upcoming election. This type of "trade" will be examined in greater depth in Chapter 8.

4. J. Schlesinger, "Systems Analysis and the Political Process," Journal of Law and Economics, October 1968, p. 281.

5. In a nutshell, the conclusions of Keynesian economics lead to the unfortunate premise that government intervention in the economy can frequently be optimal. The usually specious notion that "government can create (net) jobs" (with the exception of the next footnote, deficit financing's short-term effects, and when prices "fail to adjust") is a stubborn holdover from this theory. See: R. Vedder and L. Galloway's Out of Work (New York: Holmes and Meier, 1993) for an excellent neo-classical/Austrian treatment of the Great Depression and Keynesian economics.

6. H. Hazlitt, Economics in One Lesson, New York: Crown, 1946, p. 17.

7. Expenditures on infrastructure may be an exception assuming (1) the investment is productive (not digging holes in the ground); and (2) the private sector is hampered by the "public goods" aspect of the investment. The difference is the positive externalities borne by people completely independent of those receiving the income transfer. In other words, taxpayer A benefits in addition to recipient B. For instance, with a "needed" bridge or road, the cost of transport for everybody would diminish with less traffic congestion or fewer potholes. Of course, government can do many other things to encourage economic growth and job creation. These include the provision of secure property rights, law and order, a stable monetary system, etc.

8. H. Schlossberg draws an analogy to alchemy-- the fictitious practice of turning lead into gold. Both give "the illusion of creating wealth where none existed before. But all (they do) is redistribute the wealth that is already present" (Idols for Destruction, Wheaton, IL: Crossway Books, 1990, p. 90).

9. Hazlitt, Economics in One Lesson, p. 15.

10. OPEC has had only limited success. DeBeer's has been effective because it controls both the supply and demand sides of the diamond market. Russia's vast store of diamonds and its emergence into Western markets may end this cartel as well.

11. W. Williams, All It Takes Is Guts, Washington, D.C.: Regnery Gateway, 1987, p. 68.

12. Whether the policy is "fair" or not is immaterial here. I merely seek to illustrate its redistributive element. Another option would be to take the money from the school's general operating budget. This would presumably decrease the quality of some other aspect of the students' education-- a transfer "from consumers to producers," from students to professors.

13. "Hidden Monopolies: Driving Up Prices for Consumers," U.S. News and World Report, 2/3/92, pp. 42-48.

14. Ibid.

15. See also: D. Lee and R. McKenzie, "Helping the Poor through Governmental Poverty Programs: The Triumph of Rhetoric over Reality," in Public Choice and Constitutional Economics, ed. J. Gwartney and R. Wagner, Greenwich, CT: JAI Press, 1988.