The Rich – And Poor – Are Getting Richer

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In 1995, according to the U.S. Department of Commerce, the fifth of U.S. households with the lowest incomes received only 3.7 percent of all household income, down from 4.3 percent in 1980. The top quintile, on the other hand, received about 48.7 percent of all income in 1995, up from 43.7 percent in 1980. Does this mean that the rich are getting richer and the poor, poorer? No, for three reasons.

First, the government data reflects shares of income, not absolute income. A slightly lower share, if it's a share of a much higher total, is still a higher income. Between 1980 and 1995, household income as measured by the Department of Commerce rose from $3.21 trillion to $4.48 trillion, all in 1995 dollars. But the measure that the Commerce Department uses to adjust incomes to 1995 dollars is the Consumer Price Index (CPI), which overstates annual inflation by about 1 percentage point. Adjusted correctly, the average real income for households in the lowest fifth rose by 15 percent between 1980 and 1995.

Poor consumption index

Because of the problems with measuring income and adjusting for inflation, there's a better way to measure the well-being of a household: see what's in the house. Is there a washing machine, a color television, a VCR? Economists at the Federal Reserve Bank of Dallas used this method to estimate how households defined as "poor" fared between 1984 and 1994. The answer? They're doing much better. In 1984, 70.3 percent of poor households had a color TV; by 1994, 92.5 percent of poor families had one. While 3.4 percent of households had a VCR in 1984, ten years later, 59.7 percent did. And 71.8 percent of poor families had one or more cars in 1994, up from 64.5 percent in 1984.

Second, to call someone rich or poor, you have to know that person's wealth, not his income. A retiree who receives only $12,000 annually in Social Security benefits but who owns a $300,000 house with no mortgage would still be counted in the lowest fifth. It's true that income and wealth are positively correlated, but the correlation is far from perfect.

The third reason the line between those getting richer and poorer becomes blurred is the incredible income mobility that the United States enjoys. Today, people in the lowest-fifth income bracket are likely to be in a higher one in a few years. Imagine you could take a picture of everyone in the lowest quintile; nine years later, you take another picture of that quintile. How many people would be in both? Surprisingly few.

A 1992 study done by the U.S. Treasury confirmed this. After tracking before-tax income for 14,351 taxpayers between 1979 and 1988, the Treasury economists found that of the taxpayers in the bottom quintile in 1979, only 14.2 percent (or one in seven) were still there in 1988. Meanwhile, 20.7 percent had moved to the next higher fifth, 25 percent to the middle fifth, 25.3 percent to the second-highest fifth, and 14.7 percent to the highest fifth. Thus, a taxpayer in the lowest bracket in 1979 was about as likely to be in the highest fifth nine years later as to have stayed in the lowest fifth.

Why is mobility so high? The most important factor is age. Heavily represented in the bottom quintile are young people, who have just graduated from high school or college and are living on their own. Their current earnings are low, but as they age and gain skills, their earnings rise. Similarly overrepresented in the lowest quintile are retired people, who may be wealthier than the average family but don't have high incomes. Other factors matter, too. A worker who lost a job may have had a low annual income one year, but then he finds another job. Or a divorced mother may be in the lowest quintile, but nine years later she is remarried or working in a productive job and has a much higher family income.
There is an underclass of people who are born into poverty and live their whole lives that way, but it's much smaller than you might think. For most of the people classified by the government as poor based on their income, poverty is temporary. In the ten years from 1969 to 1978, for example, only 2.6 percent of the population was classified as poor for eight years or more. During that same period, 24.4 percent were classified as poor for at least one year. Of the "poverty spells" experienced by the nonelderly, 43 percent occurred when the marriage ended in divorce, a child was born, or someone in the family set up an independent household.

More than 15 state governments have begun ending certain cash benefits for families, and welfare experts like Thomas Fraker, an economist with Mathematica Policy Research in Washington, D.C., are realizing that removing people from the welfare rolls hasn't left them living in the streets. In Iowa, for example, welfare rolls have declined by 30 percent in the past three years because the government is ending cash aid for about 180 families a month. In a study that tracked 137 of those families, Mr. Fraker found that about half had incomes slightly higher than or equal to their previous cash welfare benefits; the other half had slightly lower incomes.

Mr. Fraker and other participants in the welfare-study industry were surprised. They shouldn't be. Set up incentives so that when welfare recipients earn a work dollar they lose a welfare dollar, and many of them won't bother earning any income (or won't bother to report it). But tell them credibly that their welfare will end soon, or kick them off, and they'll come up with ways of earning a living. The government could make it easier for them by ending the minimum wage, which prices low-skilled workers out of the market, and by ending other government-imposed rules that prohibit them from owning taxicabs, dressing hair, cutting down trees, selling food out of kiosks, and doing other productive work. Fortunately, even with these barriers in place, former welfare recipients are making it.

Be like Mike

Some people think it's unfair that income is distributed so unequally. But in a free society, income is not distributed. We get our income (gifts aside) the old-fashioned way: we earn it. Society doesn't wake up one morning and decide that Michael Jordan deserves $10 million for playing basketball and $30 million for advertising consumer products. Instead, Michael Jordan wakes up every morning, as he has for more than 15 years, with a fierce determination to stay in tremendous physical shape, practice for hours a day, and be the incredibly competent athlete that he is. Then millions of basketball fans and consumers decide, one by one, to spend a little more time watching Michael on TV or a few dollars more for the products he advertises.

Whenever you hear that the top 20 percent of household incomes receive almost half of all income, what is really meant is that the top 20 percent produce almost

50 percent of all output. Of course, this is not a totally free society, and government uses its coercive powers to take from people at every income level to give to others at every income level. But even in a free society, incomes would be highly unequal.

Bigger staffs, bigger incomes

People often assume that households in the top fifth have the same number of people working as households in the bottom fifth. This assumption is grossly mistaken. For every ten families in the bottom fifth of the income distribution in 1989, for example, eight people were working. By contrast, there were 23 workers for every ten families in the top fifth. In other words, one main reason that families are in the top fifth is that they often have three times as many workers per family as has the bottom fifth. The poorest sector includes numerous single mothers, many of them on welfare, while the top fifth includes a disproportionately high number of two-earner married couples along with, presumably, some working teenagers or young adults.

The whole focus on income inequality is mistaken. The vast majority of Americans are doing as well as we are because a million or so are making a lot of money figuring out how to create new products and new ways to increase our productivity. Show me an economy with equal incomes and I'll show you an economy that's in the toilet. Many pundits and analysts sift through the data to find inequalities in income, which isn't hard, then try to figure out how to shave off some. They usually suggest some new government program or tax that is destructive of human freedom and prosperity. Instead they should recognize the many ways that governments hold people down--in the United States and elsewhere--and figure out how to end those oppressive measures.