How Capitalism Will Save Us

Aren't The Rich Getting Richer At Other People's Expense?

Steve Forbes and Elizabeth Ames 11.03.09, 6:00 PM ET

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Q: Don't the numbers show that the poor are slipping while the rich are getting richer?

A: No. The Real World truth is that over recent decades, all groups have gotten richer.

The era of 1982-2007 may well go down in history as a golden age of growth produced by a succession of promarket government reforms--most notably, the tax cuts of Ronald Reagan and George W. Bush, as well as the capital gains tax cut of Bill Clinton. A boom in high technology, finance, and other sectors created numerous newly rich individuals. This wealth was not at the expense of the poor. Everyone profited from millions of new jobs, products, and services.

Yet even in good times, despite countless positive economic indicators, critics of capitalism insisted that the longest boom in the nation's history benefited only “the rich,” while the poor lost ground.

Exhibit A, some say, is the Gini coefficient, a government ratio measuring income distribution. In 2005 it reached its highest level ever according to the U.S. Census Bureau, 0.0462, reflecting a historic level of “income inequality,” an unprecedented gulf between rich and poor. Further proof, they say, is provided by Census Bureau statistics showing that the percentage of Americans living below the poverty line has remained virtually unchanged since the 1960s--around 12.5 percent.

These numbers supposedly provide irrefutable evidence that the free-market policies of the past three decades simply haven't worked. In the words of Hillary Clinton, they've delivered “trickle-down economics without the trickle.”

The problem is that many experts--on both ends of the political spectrum--say the government's poverty numbers are frequently misrepresented. Some believe they're just plain wrong.

Let's look at those income inequality numbers. Yes, there is a wider gulf between poor and rich incomes today than in years past. But it's not because the poor are falling behind, but because more low-income people than ever are coming here.

Between 500,000 and more than one million immigrants, many of them poor, are admitted to the United States each year. This does not include the one million to two million illegals who annually enter the United States. (Obviously, in times of recession, particularly a severe one, the number of newcomers temporarily declines.)

According to Brink Lindsey of the Cato Institute, author of *The Age of Abundance: How Prosperity Transformed America's Politics and Culture,* the portion of the total U.S. population born in foreign countries jumped from 5 percent in 1974 to 12 percent in 2004. Today's top points of origin are not the European nations as they were in years past, but the world's poorest countries, such as Mexico, Haiti, Cuba, the Dominican Republic, Nicaragua, and El Salvador, among others.

Even the most mathematically challenged among us would acknowledge that the influx of so many tens of thousands of low-skilled, low-income people is going to widen the extremes of income in this country.

This flood of immigrants raises the question, would so many be breaking their necks to come here--sometimes paying small fortunes to smugglers and risking their lives--if they believed the United States was a place where *the poor got poorer*? Media fantasies of American affluence are not the only thing drawing so many hundreds of thousands, legally and otherwise, to our shores and across our borders. They are motivated by the experiences of relatives, friends, and friends of friends who have conveyed an irresistible message: America is a place *where you have a better chance to get ahead and even get rich.*

That's what the income inequality numbers don't show: income mobility, the movement between income levels in our economy. Few of us remain at the same income level throughout our lives. We move up and sometimes down depending on our age, our career advancement, and fluctuations in the economy.

When you look at the statistics for income mobility, the numbers show that the poor are doing anything but standing still. America's democratic capitalist society is more upwardly mobile than at any other time in history.

According to a U.S. Treasury Department study of American taxpayers, about half of those in the lowest income group when filing their tax returns in 1996 moved into a higher income category by 2005. Twenty-five percent moved into a middle- or upper-income group, while more than 5 percent moved into the highest quintile.

Diana Furchtgott-Roth, former chief economist at the U.S. Department of Labor, says that this upward mobility is reflected in a dramatic improvement in living standards among low-income people over the past two decades:

> In 1985, 38% of poor households owned a home--by 2005 it was 43%. And these homes were of better quality than the 1985 homes. In 1985, 17% of these homes had central air conditioning, and in 2005, 50% did. Fifty-six percent of homes owned by poor households had washing machines in 1985, and in 2005, it was 64%.

The *Wall Street Journal* observed that mobility runs in both directions. Among those with the very highest incomes in 1996--the top 1/100 of 1 percent--only 25 percent remained in the group in 2005.

Nor does greater income equality mean a fairer society. Journalist Hedrick Smith discovered this as a *New York Times* correspondent in the communist Russia of the 1970s. On paper, there may not have been income inequality. But there were still dramatic disparities:

> Money is a poor yardstick in Russia. Earnestly, I asked Intourist guides, queried my Russian office interpreters, went to factories or engaged people in conversation in restaurants, inquiring how much they earned, how much they spent on food or rent, how much it cost to buy a car, trying to compare living standards. I busily went on making computations until Russian friends tipped me off that it was not money that really mattered but access or *blat ...* influence or connections.

“Rich people” in the old Soviet Union may not have had American-style bank accounts. But they enjoyed special privileges off-limits to most Russians--like access to special stores with rare consumer goods, as well as the right to travel. Incomes in Russia may have been more equal. But there was less fairness: power and material wealth were concentrated in the hands of a tiny elite whose position was based on political favors and power.

And what about that other oft-cited statistic--the 12.5 percent of Americans who have supposedly been stuck for decades at an income below the poverty line? In 2007, American Enterprise Institute analyst Douglas J. Besharov testified before the House of Representatives Ways and Means Committee that “many on the left as well as the right” believe the methodology used to produce that Census Bureau number is highly flawed and is very likely overstating the nation's level of poverty.

The Census Bureau's formula for calculating “income” understates things like self-employment income, which is not always reported. It also does not include numerous “in kind” benefits from government programs, such as food stamps and Medicaid. Nor does it encompass cash payments from government programs such as unemployment insurance and workers' compensation. Besharov says that's only the beginning of a dizzying list of flaws. Not all errors involve underreporting. But when they're all tallied up, Besharov says the net effect is a dramatic understatement of real income.

What would the poverty rate be if the Census Bureau used a Real World methodology? According to Besharov, the percentage of Americans living in poverty is probably a fraction of the government's estimate--around 5.4 percent.

Even Democrats on the congressional Joint Economic Committee agree that there has been “much greater progress in poverty reduction over the last two decades than the official poverty measure would indicate.”

Some go beyond Besharov's critique to question the government's fundamental definition of *poverty.* Nicholas Eberstadt of the American Enterprise Institute says the problem with the oft-cited poverty numbers is--as the critics noted above have suggested--they confuse “income” with standard of living.

He explains, “For lower-income people especially, income tends to be an unreliable predictor of true living standards.” Many people who are today labeled as “poor” by the U.S. government actually have a higher living standard than those above the poverty line in the 1960s and '70s. “In 1999, nearly 36 percent of all ‘poverty level' African American households had central air conditioning--well over twice the figure for America's white nonpoverty population in 1970.”

The government has also branded as “poor” levels of material wealth that would be considered affluent elsewhere in the world. For instance, according to the Census Bureau, over three-quarters of a million “poor” persons own homes worth over $150,000; and nearly 200,000 “poor” persons own homes worth over $300,000. These numbers do not reflect the hundreds of thousands of people who became homeowners during the subprime binge of 2004-2006. Even with substantial defaults of these particular mortgages, the fact remains that hundreds of thousands of supposedly poverty-stricken people owned valuable homes.

A study in the 1990s found that an American considered “poor” in the eyes of the Census Bureau has one-third more living space than the average Japanese citizen and four times as much living space as the average Russian.

Eberstadt believes “the poverty rate misleads the public and our representatives, and it thereby degrades the quality of our social policies. It should be discarded for the broken tool that it is--and a poverty rate worthy of the name should be crafted anew in its place.”

Another seldom-appreciated fact is that the gap between rich and poor often grows, at least temporarily, when an economy is expanding. Economist Brian Wesbury offers an enlightening explanation of why this happens:

> [I]ncomes at the top (earned by entrepreneurial innovators or early-technology-adopters) rise more rapidly. This divergence happens whenever growth picks up due to technological innovation. And it is even more pronounced in recent decades because of technology.
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> For example, Michael Jordan and Tiger Woods earn much more than Larry Bird or Jack Nicklaus ever did because of the global reach of television. A rising income gap signals growth and opportunity for investors and the economy, and should not be viewed as a problem in a free economy. Income gaps in third-world countries, ruled by dictators, are a more serious development because they reflect exploitation and an abuse of political advantage.

As we've noted, equal incomes do not necessarily signify a healthy economy--and often they mean just the opposite. There was little inequality in the old Soviet Union, or, for that matter, economically impoverished communist Cuba. There was a lot less income inequality in the United States during the Great Depression--and there's probably less now, during the current recession. There's little income inequality when almost everyone is poor.

Real World Lesson

Statistics measuring poverty and “income inequality” are snapshots in time and essentially meaningless as measures of fairness or mobility.

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