20 INCOME INEQUALITY AND POVERTY

WHAT'S NEW IN THE SIXTH EDITION:

There are two new *In the News* features on "What's Wrong with the Poverty Rate?" and "The Root Cause of a Financial Crisis."

LEARNING OBJECTIVES:

By the end of this chapter, students should understand:

- the degree of economic inequality in our society.
- some problems that arise when measuring economic inequality.
- how political philosophers view the government's role in redistributing income.
- the various policies aimed at helping poor families escape poverty.

CONTEXT AND PURPOSE:

Chapter 20 is the third chapter in a three-chapter sequence that addresses the economics of labor markets. Chapter 18 developed the markets for the factors of production. Chapter 19 extended the basic supply-and-demand model to help explain the wide variation in wages we find in the economy. Chapter 20 addresses the measurement of the distribution of income and looks at the role the government plays in altering the distribution of income.

The purpose of Chapter 20 is to address income distribution. The discussion proceeds by answering three questions. First, how much inequality is there? Second, what do different political philosophies have to say about the proper role of government in altering the distribution of income? And third, what are the various government policies that are used to help the poor?

KEY POINTS:

- Data on the distribution of income show wide disparity in our society. The richest fifth of families earns about ten times as much income as the poorest fifth.

- Because in-kind transfers, the economic life cycle, transitory income, and economic mobility are so important for understanding variation in income, it is difficult to gauge the degree of inequality in our society using data on the distribution of income in a single year. When these factors are taken into account, they tend to suggest that economic well-being is more equally distributed than is annual income.

- Political philosophers differ in their views about the role of government in altering the distribution of income. Utilitarians (such as John Stuart Mill) would choose the distribution of income to maximize the sum of utility of everyone in society. Liberals (such as John Rawls) would determine the distribution of income as if we were behind a "veil of ignorance" that prevented us from knowing our stations in life. Libertarians (such as Robert Nozick) would have the government enforce individual rights to ensure a fair process but then not be concerned about inequality in the resulting distribution of income.

- Various policies aim to help the poor—minimum-wage laws, welfare, negative income taxes, and in-kind transfers. While these policies help some families escape poverty, they also have unintended side effects. Because financial assistance declines as income rises, the poor often face very high effective marginal tax rates, which discourage poor families from escaping poverty on their own.

CHAPTER OUTLINE:

I. The Measurement of Inequality

   A. To understand the distribution of income, we want to address four questions.

      1. How much inequality is there in our society?

      2. How many people live in poverty?

      3. What problems arise in measuring the amount of inequality?

      4. How often do people move among income classes?

   B. U.S. Income Inequality

> Encourage students to bring their textbooks to class on the day that you cover this chapter so they can see these tables and charts up close while you are discussing them. An alternative would be to provide handouts or use overheads or PowerPoint® slides of the tables and charts. You may also want to check current events for any new legislation that modifies the rules under which government assistance programs operate.

      1. Table 1 shows the distribution of income in the United States by quintile.

Table 1

      2. Table 2 shows the distribution of income in the U.S. over time.

Table 2

a. Throughout the past several decades, the bottom fifth of families has received about 4 to 5 percent of income, while the top fifth has received 40 to 50 percent of income.

b. From 1935 to 1970, the distribution gradually became more equal. Since 1970, this trend has reversed itself.

C. Inequality around the World

1. Figure 1 compares the income distribution in twelve countries.

Figure 1

2. The U.S. has more income inequality than other economically advanced countries (such as Japan, Germany, Canada, or the United Kingdom), but a more equal distribution of income than many developing countries (such as South Africa, Mexico, or Nigeria).

D. The Poverty Rate

1. Definition of **<u>poverty rate</u>: the percentage of the population whose family income falls below an absolute level called the poverty line.**

2. Definition of **<u>poverty line</u>: an absolute level of income set by the federal government for each family size below which a family is deemed to be in poverty.**

a. In 2008, the poverty line for a family of four was $22,025.

b. In 2008, the poverty rate was 13.2 percent.

3. Figure 2 shows the poverty rate in the United States since 1959.

Figure 2

a. The poverty rate fell from 22.4 percent in 1959 to a low of 11.1 percent in 1973.

b. Since 1973, the increase in income inequality in the United States has prevented the poverty rate from declining further.

4. Table 3 lists the poverty rates from 2008 for different groups of people in the United States.

Table 3

a. Poverty is correlated with race. Blacks and Hispanics are more likely to live in poverty than are whites.

b. Poverty is correlated with age. Children are more likely to live in poverty and the elderly are less likely to live in poverty.

c. Poverty is correlated with family composition. Families headed by a female adult without a spouse present are more likely to live in poverty than a family headed by a married couple.

E. Problems in Measuring Inequality

1. In-Kind Transfers

   a. Definition of **<u>in-kind transfers</u>: transfers to the poor given in the form of goods and services rather than cash.**

   b. Because standard measurements of income inequality are based on a family's money income, they do not take into account these in-kind transfers.

   c. A study by the Census Bureau showed that, if in-kind transfers were included in money income at their market value, the number of families living in poverty would decline by about 10 percent.

2. The Economic Life Cycle

   a. Definition of **<u>life cycle</u>: the regular pattern of income variation over a person's life.**

   b. Young workers typically have low incomes. Income rises as the worker matures and gains experience, peaks around age 50, and then declines until the worker retires at age 65.

   c. People borrow and save to smooth out life-cycle changes in income. Borrowing often occurs when the individual is young, and most individuals save during middle age.

3. Transitory versus Permanent Income

   a. Definition of **<u>permanent income</u>: a person's normal income.**

   b. To gauge inequality of living standards, the distribution of permanent income is more relevant than the distribution of annual income.

   c. Because permanent income excludes transitory changes in income, permanent income is more equally distributed than is current income.

4. *Case Study: Alternative Measures of Inequality*

   a. A 2008 study by economists at the Federal Reserve Bank of Dallas shows how different measures of inequality lead to dramatically different results.

   b. Taking tax payments into account or examining consumption rather than income shows that inequality in the material standards of living is much smaller than inequality in annual income.

5. *In the News: What's Wrong with the Poverty Rate?*

   a. It is often difficult to determine who is poor.

   b. This is an article by economist Rebecca Blank that argues we need better information to accurately measure poverty.

F. Economic Mobility

1. Economic mobility is the movement of people among income classes and occurs often in the U.S. economy.

2. Because economic mobility is great, many of those below the poverty line are there only temporarily.

3. Economists have found substantial mobility in terms of economic success from generation to generation.

4. The U.S. economy is filled with self-made millionaires. Approximately 80 percent of the millionaires in the United States made their money on their own as opposed to inheriting it.

II. The Political Philosophy of Redistributing Income

A. Utilitarianism

1. Definition of **utilitarianism: the political philosophy according to which the government should choose policies to maximize the total utility of everyone in society.**

2. Definition of **utility: a measure of happiness or satisfaction**.

3. The founders of utilitarianism are Jeremy Bentham and John Stuart Mill.

4. The utilitarian case for redistributing income is based on the assumption of diminishing marginal utility.

   a. An extra dollar of income provides a poor person with more additional utility than an extra dollar would provide to a rich person.

   b. As a person's income rises, the extra satisfaction from an additional dollar of income declines.

5. However, utilitarians do not believe that all incomes should be equal.

   a. Principle #3: People respond to incentives.

   b. If all incomes were to be equalized, this would reduce the incentive to work hard. If individuals do not work as hard, total income falls, which lowers total utility.

   c. Thus, in a utilitarian's opinion, the government must balance the gains from greater equality against the losses caused by the distorted incentives.

B. Liberalism

1. Definition of **liberalism: the political philosophy according to which the government should choose policies deemed to be just, as evaluated by an impartial observer behind a "veil of ignorance."**

2. This is a political philosophy developed by John Rawls.

3. Rawls considered what income distribution a person would consider just if that person did not know whether he or she would end up at the top, bottom, or in between.

    a. Rawls believed that a person would be most concerned about being at the bottom of the income distribution.

    b. Thus, public policy should aim to raise the welfare of the worst-off person in society.

    c. Definition of the **maximin criterion: the claim that the government should aim to maximize the well-being of the worst-off person in society.**

    d. This idea suggests that we should consider income redistribution as a form of social insurance.

    e. Definition of **social insurance: government policy aimed at protecting people against the risk of adverse events.**

    f. It is not clear that rational people would be so truly risk averse as to follow the maximin criterion. If a person were to treat all outcomes as equally likely, the best policy would be to maximize the average utility of the members of society (as suggested by utilitarianism).

C. Libertarianism

1. Definition of **libertarianism: the political philosophy according to which the government should punish crimes and enforce voluntary agreements but not redistribute income.**

2. Libertarians believe that society itself earns no income; only individual members of society earn income.

3. Libertarians also believe that the government should not take income from some individuals and give it to others to achieve any particular distribution of income.

4. Libertarians conclude that equality of opportunities is more important than equality of incomes. Thus, they believe that the government should enforce individual rights to ensure that everyone has an equal opportunity to make the most of his or her talents and achieve success.

III. Policies to Reduce Poverty

A. Minimum-Wage Laws

1. For workers with low levels of skill and experience, a high minimum wage forces the wage above equilibrium.

    a. This leads to higher unemployment among those groups of workers affected by the minimum wage.

    b. Although those workers who remain employed benefit from a higher wage, those who might have been employed at a lower wage are worse off.

2. The magnitude of the effect depends on the elasticity of demand for labor.

    a. If the demand for labor is elastic, firms will lower employment more than if the demand is inelastic.

    b. This is especially true in the long run, when firms can adjust to the higher wage more fully.

3. Critics of the minimum wage also point out that many teenagers earning the minimum wage are from middle-class families, so that a high minimum wage does a bad job of targeting the poor.

B. Welfare

1. Definition of **welfare: government programs that supplement the incomes of the needy.**

2. Temporary Assistance for Needy Families (TANF) and Supplemental Security Income (SSI) are two welfare programs.

3. A common criticism of these programs is that they create incentives for people to become needy.

    a. These programs may encourage families to break up, because many families qualify only if the father is absent.

    b. These programs may also encourage illegitimate births, because many poor, single women qualify only if they have children.

Million Dollar Baby, Chapter 21. After making it big, Maggie (Hillary Swank) buys a house for her family. However, her mother refuses to accept it because she fears she will become ineligible for welfare. This clip does a great job of motivating a discussion about the long-term effects of poverty and the welfare system.

4. Proponents argue that being a poor, single mother on welfare is not a life that someone would choose. Trends also indicate that, while the amount of welfare benefits (adjusted for inflation) has fallen since the 1970s, the percentage of children living with a single parent has risen.

5. The Earned Income Tax Credit works like a negative income tax for the working poor.

C. In-Kind Transfers

1. The federal government provides the poor with food stamps and Medicaid.

2. Advocates of in-kind transfers argue that these make sure that the poor receive what they need most.

3. Advocates of cash payments argue that the government cannot know what goods and services the poor need the most.

D. Anti-Poverty Programs and Work Incentives

1. Many policies for the poor have the unintended effect of discouraging work.

    a. A person discouraged from working loses the on-the-job training that a job might offer.

    b. Children will not get to see their parents with a full-time job and this may impair their own ability to find and hold a job when they get older.

***SpongeBob SquarePants, "Can You Spare a Dime?"* (Season 3).** Squidward quits his job at the Krusty Krab. When SpongeBob sees Squidward living on the street, he invites him to live with him until he finds a job. However, Squidward starts to take advantage of SpongeBob's hospitality and delays looking for work. This is a nice episode to talk about the disincentive effects of the welfare system.

2. Welfare, Medicaid, food stamps, and the Earned Income Tax Credit all have eligibility requirements that are tied to income level.

    a. As a family's income rises, it becomes ineligible for these programs.

    b. When all programs are taken into account, these families face marginal tax rates that are very high.

3. One possible solution would be to gradually phase out the benefits gradually as the family's income level rises. However, this would raise the costs of these programs substantially.

4. In 1996, the government passed a welfare-reform law that limits the amount of time that any person can collect welfare.

E. *In the News: The Root Cause of a Financial Crisis*

1. In 2008 and 2009, the U.S. experienced a financial crisis resulting in a deep recession.

2. This is an opinion piece by an economist suggesting that this crisis was caused by the changing distribution of income in the United States.

SOLUTIONS TO TEXT PROBLEMS:

Quick Quizzes

1. The poverty rate measures the percentage of the population whose family income falls below an absolute level called the poverty line. It tells you something about the distribution of income at the lower end of the income scale.

    Three potential problems in interpreting the measured poverty rate are: (1) in-kind transfers are not accounted for in the poverty rate, so the poverty rate overstates the amount of poverty; (2) the poverty rate is based on annual income, but income over the life cycle is much more equally distributed than annual income; and (3) the poverty rate is affected by temporary changes in income, but would be better measured by looking at permanent income.

2. Based on the assumption of diminishing marginal utility of income, a utilitarian would favor some redistribution of income from Pam to Pauline because it would increase the total utility of society. A liberal would want to maximize the utility of the least well-off person in society, so a liberal would favor even greater redistribution. A libertarian would not want to redistribute income from Pam to Pauline as long as the process of earning income was a fair one.

3. Policies aimed at helping the poor include minimum-wage laws, welfare, a negative income tax, and in-kind transfers. Minimum-wage laws can help the working poor without any cost to the government but have the disadvantage of causing unemployment among some workers. Welfare assists the poor with direct aid but creates incentives for people to become needy. The negative income tax is a good way to implement a program of financial aid for the poor and does not distort incentives as much as some other programs do, but it may support those who are lazy and unwilling to work. In-kind transfers provide goods and services directly to the poor, ensuring that the poor get necessities such as food and shelter, but the government may not know what the poor need the most.

Questions for Review

1. The richest fifth of the U.S. population earns about ten times as much income as the poorest fifth.

2. The United States has a more unequal distribution of income than countries like Germany and Canada, but a more equal distribution than many developing countries, such as Mexico and Nigeria.

3. In the U.S. population, the groups most likely to live in poverty are blacks and Hispanics, children, and families headed by a female adult without a spouse present.

4. Since people may have temporarily high or low income and since income varies over the life cycle (people's incomes are lower when young and higher when older), annual income does not represent true inequality in living standards.

5. A utilitarian would like everyone to have equal incomes, but would recognize that redistributing income distorts incentives, so would proceed only part way to that goal. A liberal would go further than a utilitarian in equalizing incomes, since a liberal would focus on the well being of the worst-off person in society. A libertarian would not care about equalizing incomes at all as long as the process of getting income is fair.

6. In-kind transfers are beneficial because they ensure that the poor get what they need most. In particular, they get food and shelter instead of alcohol and drugs. But in-kind transfers are not as beneficial to the recipients as cash because they provide no opportunity for substitution into more highly valued goods. The poor are in the best position to know what they need.

7. Antipoverty programs can discourage the poor from working because they effectively tax away earnings by significantly reducing benefits when a person earns income. This disincentive could be reduced by reducing the benefits more gradually, but the program would be much more expensive.

Problems and Applications

1. The factors contributing to the increase in income inequality in the United States during the past 30 years are the breakup of families, making poor families even poorer, and the increase in the number of two-career families, making rich families even richer.

2. The percentage of children in families with income below the poverty line is almost twice the percentage of the elderly in such families because the Social Security system supports the elderly quite well, but the TANF (Temporary Assistance for Needy Families) program has incentive effects that tend to keep families from working their way out of poverty.

3. Students' current incomes are substantially less than their permanent incomes, so current incomes don't reflect their standards of living very well. They may borrow now or be supported by their parents, but their college education will pay off with higher future incomes.

4. a. To increase economic mobility within a generation, the government could support training programs (to provide skills to unskilled workers) and workfare instead of welfare (to help the poor increase their incomes).

   b. To increase economic mobility across generations, the government might increase its support for education.

   c. The advantage of reducing spending on welfare to increase spending on programs that enhance economic mobility is that it gives people greater incentive to work hard to get ahead. The disadvantages are that such programs are expensive and are hard on those who do not make it.

5. Community 1 has ten families with income of $100,000 each and ten families with income of $20,000 each. Community 2 has ten families with income of $200,000 each and ten families with income of $22,000 each.

   a. Community 2 has more unequal income than Community 1. In Community 2 the rich have nearly ten times the income of the poor, while in Community 1 the rich have only five times the income of the poor. However, the problem of poverty is likely to be slightly worse in Community 1, since the poor have lower income.

   b. Rawls would prefer the distribution of income in Community 2, since the worst-off family has more income than in Community 1.

   c. Most people will prefer the income distribution of Community 2, since both rich and poor families are better off than their counterparts in Community 1, even though inequality is greater.

   d. A utilitarian may prefer the income distribution of Community 1 because income is more equal across its citizens.

6. a. Leaks in the bucket are caused by the administrative costs of redistributing income, people who lie about their income to cheat the system, and the fact that labor supply is elastic, so that redistributive taxes reduce labor supply.

b. Generally, Republicans believe the redistributive bucket is more leaky than do Democrats. As a result, they think the government should do less redistribution of income than do Democrats.

7. a. A utilitarian would argue that the marginal utility of income for the person with an income of $10,000 is higher than the marginal utility of income for someone with an income of $30,000, so income should be redistributed.

   b. Rawls would prefer the second distribution since the worst-off person is better off than in the first distribution.

   c. Nozick would not find either more equitable. He would think the most equitable distribution is the one in which people got what they deserved. If the rules of the game are fair, either distribution is quite acceptable.

8. a. If people received cash instead of Medicaid benefits, it is unlikely that they would spend as much on health care. Instead, they would purchase other things they want or need.

   b. This suggests that we probably should not value in-kind transfers at the price the government pays for them. They may not be worth as much as their cost.

   c. Since the poor would prefer other things to Medicaid, it might be better to give them cash transfers instead.

9. a. Since the woman receives a smaller TANF benefit when she earns a dollar more, she will be less likely to work. Thus, the labor supply of low-income women will be lower as a result of the TANF program.

   b. If an individual would receive a greater benefit when she earns more income, she will be more likely to work. Thus, the EITC has a positive effect on the labor supply of low-income workers.

   c. TANF provides a safety net for those who are less likely to be successful in the labor market.

10. Utilitarians and liberals would be in favor of this policy. The marginal utility of providing healthcare to a poor person is likely to be greater than the marginal utility of the tax dollars of the wealthy individual. The program also benefits those worst off. Libertarians would not be in favor of the program because they do not favor redistribution of income if all individuals are playing on a level field.