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Income Inequality and Poverty

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A person's earnings depend on the supply and demand for that person's labor, which in turn depend on natural ability, human capital, compensating differentials, discrimination, and so on.

THE MEASUREMENT OF INEQUALITY

- How much inequality is there in our society?
- How many people live in poverty?
- What problems arise in measuring the amount of inequality?
- How often do people move among income classes?

**Table 1 The Distribution of Income
in the United States: 2000**

Group	Annual Family Income
Bottom fifth	Under \$24,000
Second fifth	\$24,001–\$41,000
Middle fifth	\$41,001–\$61,378
Fourth fifth	\$61,379–\$91,700
Top fifth	\$91,701 and over
Top 5%	\$160,250 and over

U.S. Income Inequality

- Imagine that you. . .
 - lined up all of the families in the economy according to their annual income.
 - divided the families into five equal groups (bottom fifth, second fifth, etc.)
 - computed the share of total income that each group of families received.

Table 2 Income Inequality in the United States

Year	Bottom Fifth	Second Fifth	Middle Fifth	Fourth Fifth	Top Fifth	Top 5%
2000	4.3%	9.8%	15.5%	22.8%	47.4%	20.8%
1990	4.6	10.8	16.6	23.8	44.3	17.4
1980	5.2	11.5	17.5	24.3	41.5	15.3
1970	5.5	12.2	17.6	23.8	40.9	15.6
1960	4.8	12.2	17.8	24.0	41.3	15.9
1950	4.5	12.0	17.4	23.4	42.7	17.3
1935	4.1	9.2	14.1	20.9	51.7	26.5

U.S. Income Inequality

- If income were equally distributed across all families, each one-fifth of families would receive one-fifth (20 percent) of total income.



U.S. Income Inequality

- From 1935-1970, the distribution of income gradually became more equal.
- In more recent years, this trend has reversed itself.



U.S. Income Inequality

- Reasons for Recent Increase in Income Inequality
 - The following have tended to reduce the demand for unskilled labor and raise the demand for skilled labor:
 - Increases in international trade with low-wage countries
 - Changes in technology
 - Therefore, the wages of unskilled workers have fallen relative to the wages of skilled workers.
 - This has resulted in increased inequality in family incomes.

CASE STUDY: The Women's Movement and the Income Distribution

- The percentage of women who hold jobs has risen from about 32 percent in the 1950s to about 54 percent in the 1990s.

CASE STUDY: Income Equality around the World

Country	Lowest 10%	Highest 10%	Ratio
Japan	4.8%	21.7%	4.5
Germany	3.3	23.7	7.2
Canada	2.8	23.8	8.5
India	3.5	33.5	9.6
United Kingdom	2.6	27.3	10.5
China	2.4	30.4	12.7
United States	1.8	30.5	16.9
Russia	1.7	38.7	22.8
Nigeria	1.6	40.8	25.5
Mexico	1.6	41.1	25.7
South Africa	1.1	45.9	41.7
Brazil	1.0	46.7	46.7

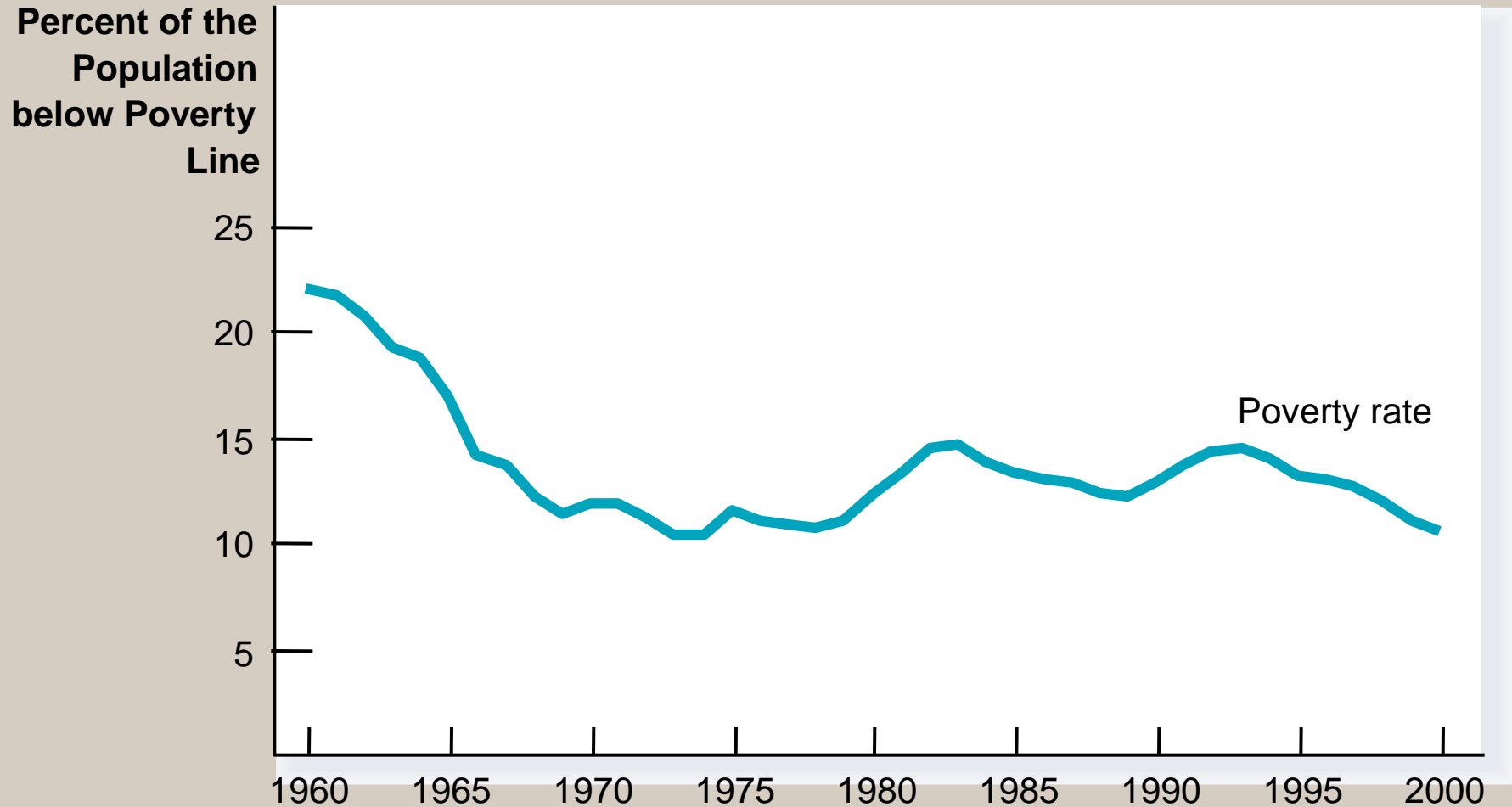
The Poverty Rate

- The *poverty rate* is the percentage of the population whose family income falls below an absolute level called the *poverty line*.

Problems in Measuring Inequality

- The Poverty Line
 - The poverty line is an absolute level of income set by the federal government for each family size below which a family is deemed to be in poverty.

Figure 1 The Poverty Rate



Problems in Measuring Inequality

- The Poverty Line and Income Inequality
 - As economic growth pushes the entire income distribution upward, more families are pushed above the poverty line because the poverty line is an absolute rather than a relative standard.
 - Despite continued economic growth in average income, the poverty rate has not declined.
 - Although economic growth has raised the income of the typical family, the increase in inequality has prevented the poorest families from sharing in this greater economic prosperity.

Table 4 Who Is Poor?

Group	Poverty Rate
All persons	11.3%
White, not Hispanic	7.5
Black	22.0
Hispanic	21.2
Asian, Pacific Islander	10.7
Children (under age 18)	16.1
Elderly (over age 64)	10.2
Married-couple families	5.6
Female household, no spouse present	27.9

Problems in Measuring Inequality

- Three Facts About Poverty
 - Poverty is correlated with race.
 - Poverty is correlated with age.
 - Poverty is correlated with family composition.

Problems in Measuring Inequality

- Data on income distribution and the poverty rate give an incomplete picture of inequality in living standards because of the following:
 - In-kind transfers
 - Life cycle
 - Transitory versus permanent income

Problems in Measuring Inequality

- In-Kind Transfers
 - Transfers to the poor given in the form of goods and services rather than cash are called *in-kind transfers*.
 - Measurements of the distribution of income and the poverty rate are based on families' money income.
 - The failure to include in-kind transfers as part of income greatly affects the measured poverty rate.

Problems in Measuring Inequality

- The Economic Life Cycle
 - The regular pattern of income variation over a person's life is called the *life cycle*.
 - A young worker has a low income at the beginning of his or her career.
 - Income rises as the worker gains maturity and experience.
 - Income peaks at about age 50.
 - Income falls sharply at retirement, around age 65.

Problems in Measuring Inequality

- Transitory versus Permanent Income
 - Incomes vary because of random and transitory forces.
 - Acts of nature
 - Temporary layoffs due to illness or economic conditions, etc.
 - A family's ability to buy goods and services depends largely on its *permanent income*, which is its normal, or average, income.
 - Permanent income excludes transitory changes in income.

Economic Mobility

- The movement of people among income classes is called economic mobility.
- Economic mobility is substantial in the U.S. economy.

Economic Mobility

- Movements up and down the income ladder can be due to:
 - Good or bad luck.
 - Hard work or laziness.
 - Persistence of economic success from generation to generation.

POLITICAL PHILOSOPHY OF REDISTRIBUTING INCOME

- What should the government do about economic inequality?
 - Economic analysis alone cannot give us the answer.
 - The question is a normative one facing policymakers.

POLITICAL PHILOSOPHY OF REDISTRIBUTING INCOME

- Three Political Philosophies
 - Utilitarianism
 - Liberalism
 - Libertarianism

Utilitarianism

- *Utilitarianism* is the political philosophy according to which the government should choose policies to maximize the total utility of everyone in society.
- The founders of utilitarianism are the English philosophers Jeremy Bentham and John Stuart Mill.

Utilitarianism

- The utilitarian case for redistributing income is based on the assumption of diminishing marginal utility.
 - An extra dollar of income to a poor person provides that person with more *utility*, or well-being, than does an extra dollar to a rich person.

Liberalism

- *Liberalism* is 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.”
- This view was originally developed by the philosopher John Rawls.

Liberalism

- Public policy should be based on the *maximin criterion*, which seeks to maximize the *utility* or well-being of the worst-off person in society.
- That is, rather than maximizing the sum of everyone's utility, one should *maximize the minimum utility*.
- This idea would allow for the consideration of the redistribution of income as a form of social insurance.

Libertarianism

- *Libertarianism* is the political philosophy according to which the government should punish crimes and enforce voluntary agreements, but *should not* redistribute income.
- Libertarians argue that equality of opportunity is more important than equality of income.

POLICIES TO REDUCE POVERTY

- Minimum-wage laws
- Welfare
- Negative income tax
- In-kind transfers

Minimum-Wage Laws

- Advocates view the minimum wage as a way of helping the working poor.
- Critics view the minimum wage as hurting those it is intended to help.

Minimum-Wage Laws

- The magnitude of the effects of the minimum wage depends on the *elasticity of the demand* for labor.

Minimum-Wage Laws

- Advocates argue that the demand for unskilled labor is relatively inelastic, so that a high minimum wage depresses employment only slightly.
- Critics argue that labor demand is more elastic, especially in the long run when firms can adjust employment more fully.

Welfare

- The government attempts to raise the living standards of the poor through the welfare system.
- *Welfare* is a broad term that encompasses various government programs that supplement the incomes of the needy.
 - Temporary Assistance for Needy Families (TANF)
 - Supplemental Security Income (SSI)

Negative Income Tax

- A *negative income tax* collects tax revenue from high-income households and gives transfers to low-income households.

Negative Income Tax

- High-income families would pay a tax based on their incomes.
- Low-income families would receive a subsidy—a “negative tax.”
- Poor families would receive financial assistance without having to demonstrate need.

In-Kind Transfers

- In-kind transfers are transfers to the poor given in the form of goods and services rather than cash.
- Food stamps and Medicaid are examples.

In-Kind Transfers

- Advocates of in-kind transfers argue that such transfers ensure that the poor get what they most need.
- Advocates of cash payments argue that in-kind transfers are inefficient and disrespectful.

Antipoverty Programs and Work Incentives

- Many policies aimed at helping the poor can have the unintended effect of discouraging the poor from escaping poverty on their own.

Antipoverty Programs and Work Incentives

- An antipoverty program can affect work incentives:
 - A family needs \$15,000 to maintain a reasonable standard of living.
 - The government promises to guarantee every family a \$15,000 income.
 - Any person making under \$15,000 has no incentive to work due to the effective marginal tax rate of 100 percent.

Antipoverty Programs and Work Incentives

- Workfare refers to a system that would require any person collecting benefits to accept a government-provided job.

Antipoverty Programs and Work Incentives

- A 1996 welfare reform bill advocated providing benefits for only a limited period of time.

Summary

- Data on the distribution of income show wide disparity in our society.
- The richest fifth of the families earns about ten times as much as the poorest fifth.
- It is difficult to gauge the degree of inequality using data on the distribution of income in a single year.

Summary

- Political philosophers differ in their views about the role government should play in redistributing income.
- Utilitarians would choose the distribution of income to maximize the sum of the utility of everyone in society.

Summary

- Liberals would determine the distribution of income as if we were behind a “veil of ignorance” that prevented us from knowing our own stations in life.
- Libertarians would have the government enforce individual rights but not be concerned about inequality in the resulting distribution of income.

Summary

- Various policies aimed to help the poor include: minimum-wage laws, welfare, negative income taxes, and in-kind transfers.
- Although each of these policies helps some families escape poverty, they also have unintended side effects.