

CHAPTER 20

Income Inequality and Poverty

PRINCIPLES OF
Economics

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Premium PowerPoint Slides
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In this chapter, look for the answers to these questions:

- How much inequality and poverty exist in our society? Video-are the poor getting poorer?
- What are the problems measuring inequality?
- What are some of the leading philosophies on the proper role of government in altering the distribution of income?
- What policies are used to fight poverty? What are the problems with these policies?

Introduction

- Equilibrium wages equal the value of workers' marginal products.
- Differences in equilibrium wages result from differences in
 - worker characteristics:
education, experience, talent, effort
 - job characteristics:
extent to which a job is pleasant and safe
- Some earnings differences due to discrimination.

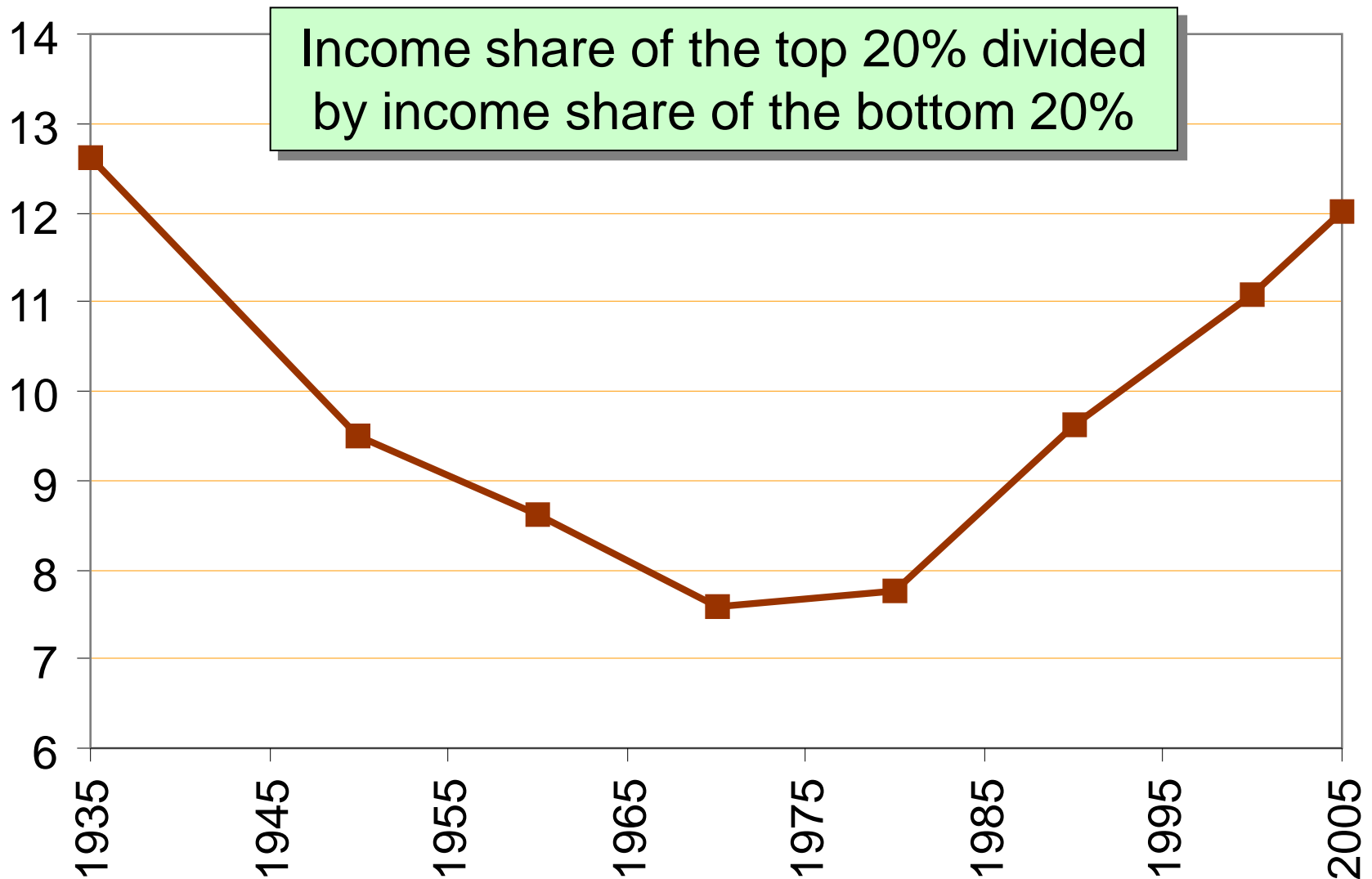
Introduction

- Even in the absence of discrimination, the income distribution in a market economy may not be equitable or otherwise desirable.
- In this chapter, we examine
 - indicators of inequality and poverty
 - philosophies about income redistribution
 - policies designed to help the poor

The U.S. Income Distribution: 2009

Group	Annual household income
Bottom fifth	Under \$20,453
Second fifth	\$20,454 – \$38,550
Middle fifth	\$38,551 – \$61,801
Fourth fifth	\$61,802 – \$100,000
Top fifth	\$100,000 and over
Top 5 percent	\$180,000 and over

U.S. Inequality Over Time



Capital Income and The Top One Percent

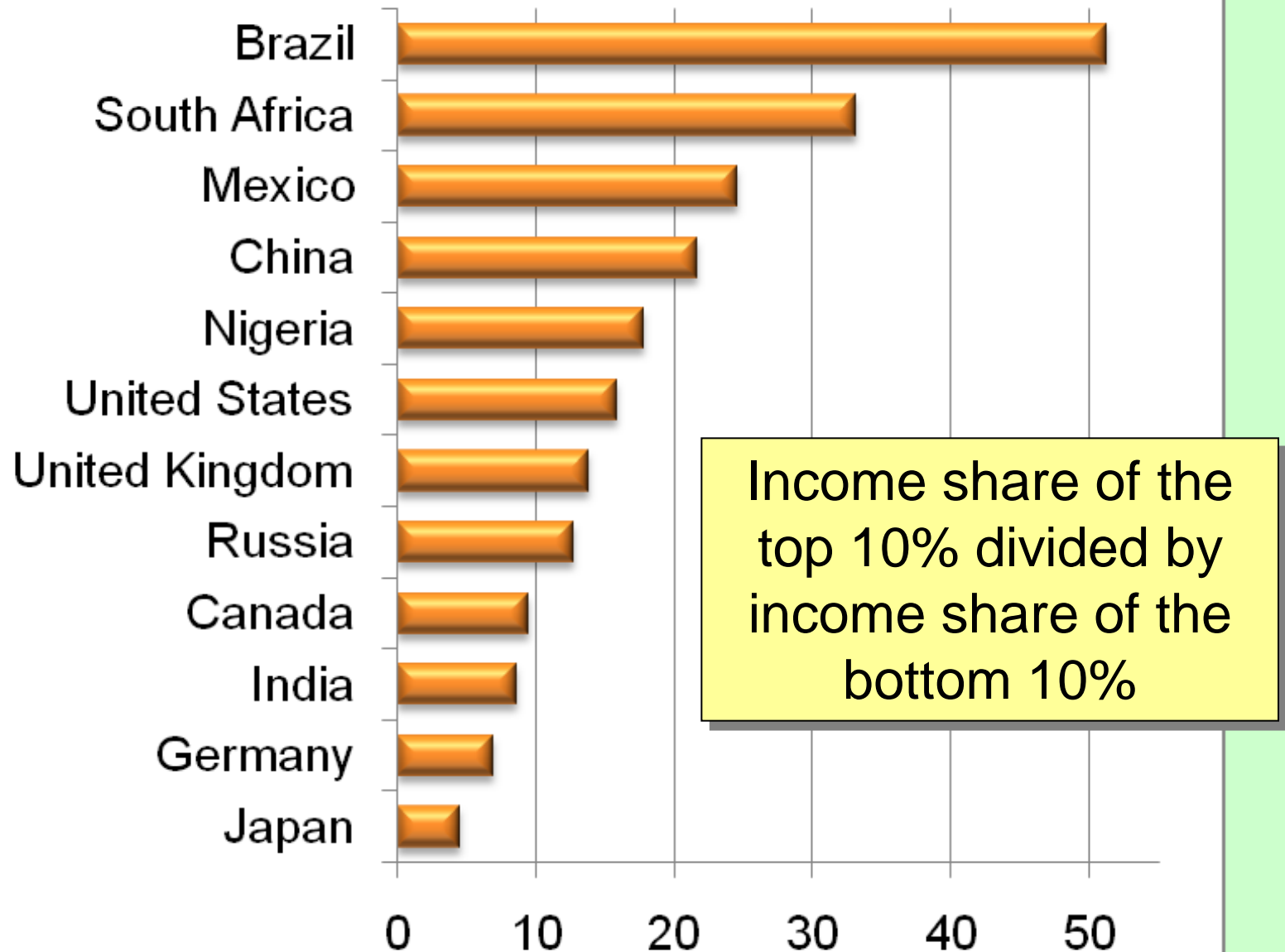
Realized capital gains are a significant share of the highest earners' income.



Note: 2008 and 2009 estimates

Sources: Congressional Budget Office. Estimates are drawn from Thomas Piketty and Emmanuel Saez, "Inequality in the United States, 1913-1998" updated through 2008, and for 2009 by Steve Kaplan, University of Chicago. The Piketty/Saez and Kaplan numbers are reduced by 36% to make them comparable to the expression of income used by the CBO. Capital gains for 2008-2009 estimated by the author.

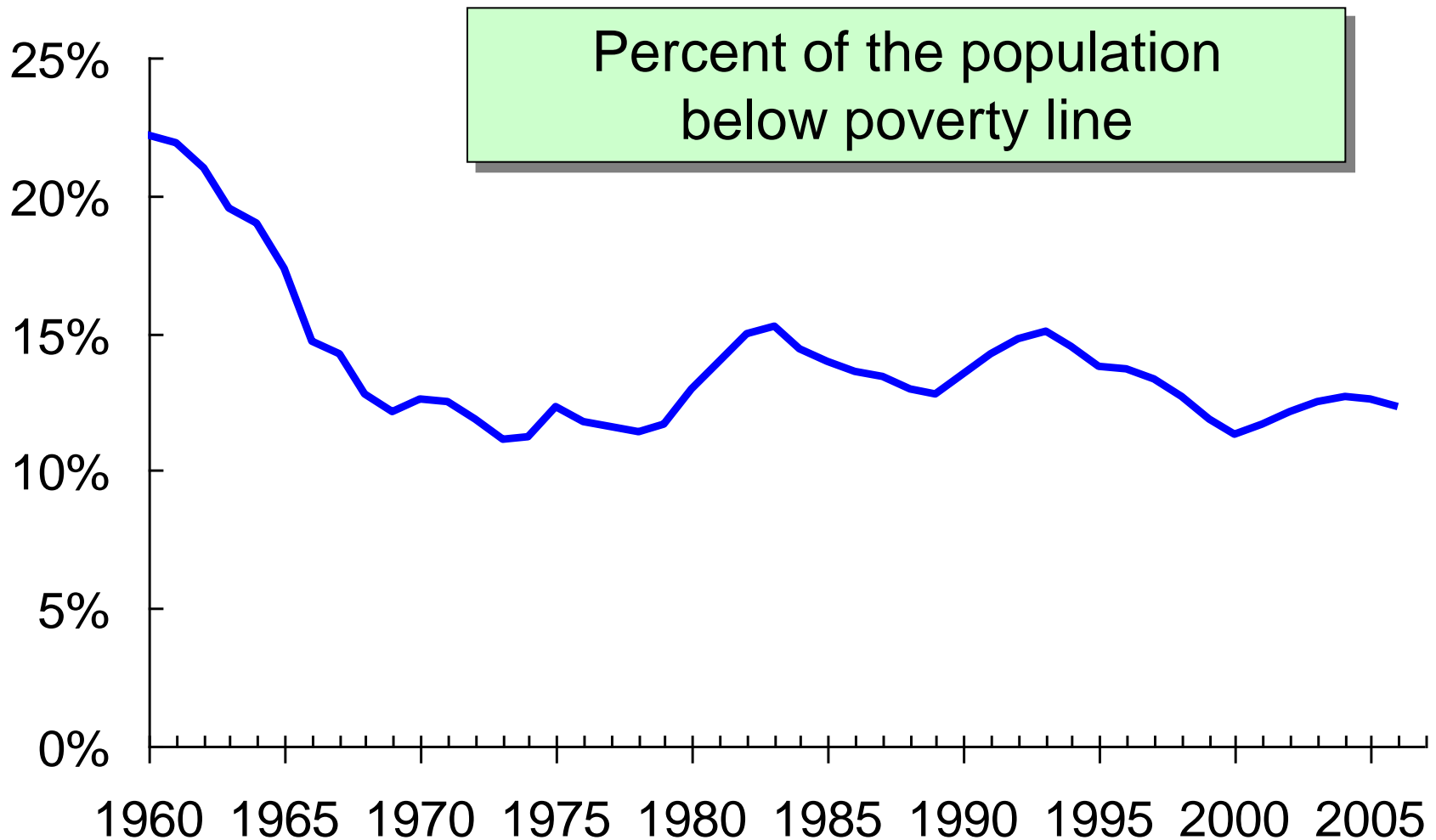
Inequality Around the World



Poverty

- : an absolute level of income set by the govt for each family size below which a family is deemed to be in poverty
- : the percentage of the population whose family income falls below the poverty line
- In 2013 in the U.S. for households of 4,
 - median family income = \$49,777
 - poverty line for family of four = \$23,350
 - poverty rate for family = 15%

U.S. Poverty Over Time



U.S. Individual Poverty Rate by Group, 2012

Group	Poverty Rate
All persons	15%
White, not Hispanic	12.3
Black	25.8
Hispanic	25.3
Asian	12.5
Children	20.1
Elderly	10.0
Married-couple families	5.8
Female household, no spouse present	29.9

Problems Measuring Inequality

1. In-kind transfers: assistance that takes the form of g&s rather than cash
 - Omitted from measures of inequality and poverty, biasing them upward
2. Life-cycle income variation: the regular pattern of income variation over a person's life
 - People can borrow and save to offset life-cycle changes in income (*e.g.*, saving for retirement).
 - Life-cycle income variation causes inequality in income but not inequality in living standards.

Problems Measuring Inequality

3. Transitory vs. Permanent Income:

- People can borrow and save to smooth out *transitory* income fluctuations.
- A better measure of inequality in living standards would be based not on current income, but on _____, a person's normal income.

4. Economic mobility: Is There Income Mobility?-video

- Many people move among income classes.
- The poverty and inequality measures discussed above do not distinguish between the temporarily poor and the persistently poor.

The Political Philosophy of Redistributing Income

We consider three philosophies:

- Utilitarianism
- Liberalism
- Libertarianism

Utilitarianism

- **Utility**: a measure of happiness or satisfaction
- **Utilitarianism**: argues that govt should choose policies to maximize society's total utility
 - Founders: Jeremy Bentham, [John Stuart Mill](#)-video
- Because of _____, redistributing income from rich to poor increases utility of the poor more than it reduces utility of the rich.
- Yet, utilitarians do not advocate *equalizing* incomes – would reduce total income of everyone due to incentive effects and efficiency losses.

Liberalism

- **Liberalism**: argues that govt should choose policies deemed to be just by an impartial observer behind a “veil of ignorance”
 - Founder: John Rawls—[Video](#)
- _____: govt should aim to maximize the well-being of society’s worst-off person
- Calls for more redistribution than utilitarianism (though still not complete equalization of incomes).
- Income redistribution is a form of **social insurance**, a govt policy aimed at protecting people against the risk of adverse events.

Libertarianism

- **Libertarianism**: argues that govt should punish crimes and enforce voluntary agreements but not redistribute income
 - Advocate: Robert Nozick-[Video](#)
- Instead of focusing on outcomes, libertarians focus

- Govt should enforce individual rights, should try to equalize opportunities.
- If the income distribution is achieved fairly, govt should not interfere, even if unequal.

Policies to Reduce Poverty

- Poor families more likely to experience
 - homelessness
 - drug dependence
 - health problems
 - teen pregnancy
 - illiteracy
 - unemployment
- Most people believe govt should provide a “safety net.” Adam Smith [Video](#)
- We now consider a few such policies...

1.

- Arguments for:
 - Helps the poor without any cost to the govt.
 - Little impact on employment if demand for unskilled labor is relatively inelastic.
- Arguments against:
 - In the long run, demand for unskilled labor is likely elastic, so minimum wage causes substantial unemployment among the unskilled.
 - Those helped by minimum wage are more likely to be teens from middle-income families than low-income adult workers.

2. ---

- **Welfare:** govt programs that supplement the incomes of the needy
 - Temporary Assistance for Needy Families (TANF)
 - Supplemental Security Income (SSI)
- Critics argue that such programs create incentives to become or remain needy, argue that welfare contributed to the rise of the single-parent family.
- However, the severity of such incentive problems is unknown.
- Proponents note that inflation-adjusted welfare benefits fell as single-parent families increased.

3.

- **Negative income tax:** a tax system that collects revenue from high-income households and gives transfers to low-income households
- Example: Taxes owed = $(1/3 \text{ of income}) - \$10,000$
 - If earnings = \$90,000, taxes owed = \$20,000
 - If earnings = \$60,000, taxes owed = \$10,000
 - If earnings = \$30,000, taxes owed = \$0
 - If earnings = \$15,000, taxes “owed” = $-\$5,000$
i.e., would receive \$5000 payment from govt
- The Earned Income Tax Credit (EITC) is similar to a negative income tax.

4.

- In-kind transfers are goods or services provided to the needy. Examples:
 - homeless shelters
 - soup kitchens
 - **food stamps**, govt vouchers redeemable for food at grocery stores
 - **Medicaid**, govt-provided healthcare for the poor
- An alternative: cash payments
 - would allow people to buy what they most need
 - but critics argue could be used for drugs, alcohol

Anti-Poverty Programs and Work Incentives

- Assistance from anti-poverty programs declines as income rises.
- The result: Poor families face high effective marginal tax rates (exceeding even 100% in some cases!).
- Such policies therefore discourage the poor from escaping poverty on their own.
- One possible solution: “**Workfare**,” a system requiring people to accept government jobs while collecting benefits.

- Cost-Benefit Analysis-video

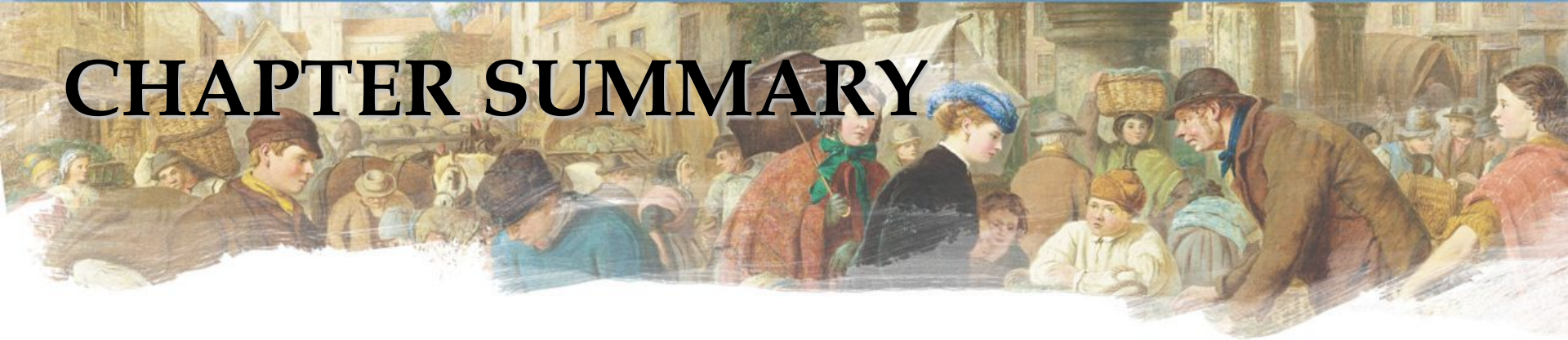
CONCLUSION

- Poverty is one of society's most serious problems.
- One of the Ten Principles from Chapter 1:
Governments can sometimes improve market outcomes.

Public policy can help reduce poverty and inequality.

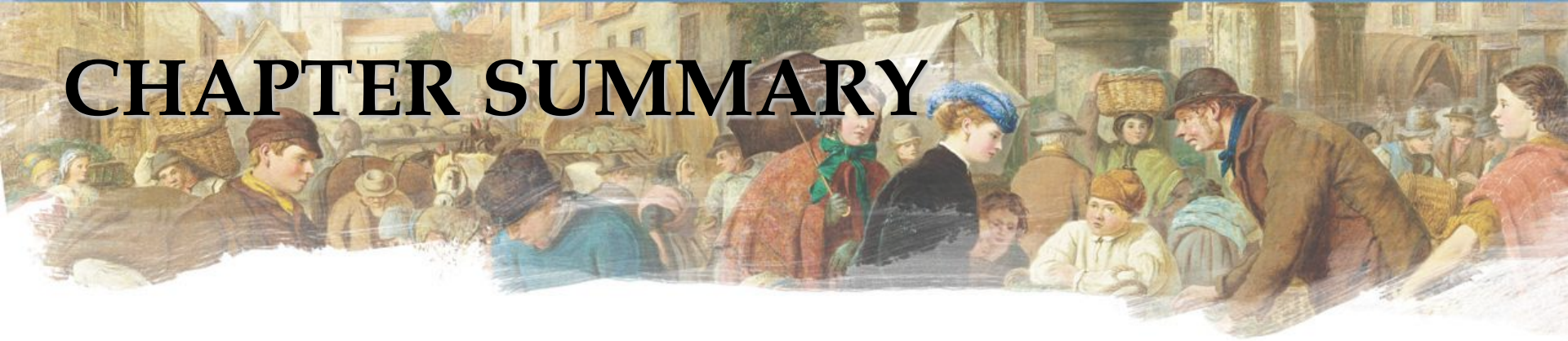
- Another principle: ***People face trade-offs.***
Policies designed to improve equity often sacrifice efficiency, so the proper scope of policy is the subject of ongoing controversy.

CHAPTER SUMMARY



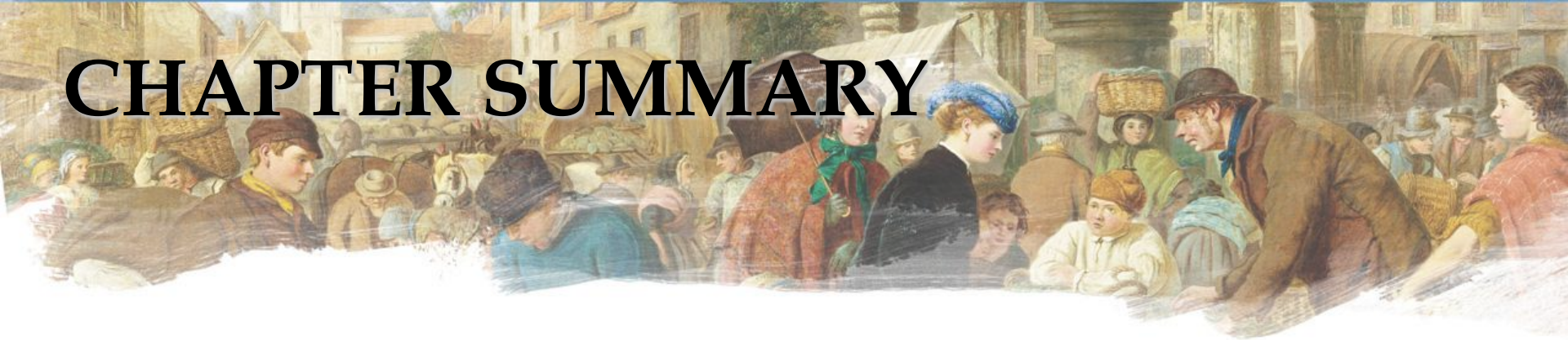
- Data on income distribution show a wide disparity in our society. The richest 20% of families earn about ten times as much as the poorest 20%.
- Problems in measuring inequality arise from in-kind transfers, the economic life cycle, transitory income, and economic mobility. When these factors are taken into account, the distribution of well-being is probably less unequal than the distribution of annual income.

CHAPTER SUMMARY



- Political philosophers differ in their views of the proper role of government in altering the income distribution. Utilitarians believe that income distribution should maximize the sum of everyone's utility. Liberals believe the government should aim to maximize the well-being of the worst-off person in society. Libertarians believe the government should aim for equality of opportunity, not equality of income.

CHAPTER SUMMARY



- Policies such as welfare, minimum-wage laws, negative income taxes, and in-kind transfers can help the poor.
- Since financial assistance falls as income rises, the poor face high effective marginal tax rates, discouraging them from escaping poverty on their own.