Chapter 20: Income Inequality and Poverty

- 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.
- This gives us an understanding of why different people make different incomes and although the “invisible hand” acts to allocate resources efficiently, it does not necessarily ensure that resources are allocated fairly.

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?

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Table 1: The Distribution of Income in the United States: 2003

<table>
<thead>
<tr>
<th>Group</th>
<th>Annual Family Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bottom Fifth</td>
<td>Under $24,117</td>
</tr>
<tr>
<td>Second Fifth</td>
<td>$24,117-$42,057</td>
</tr>
<tr>
<td>Middle Fifth</td>
<td>$42,057-$65,000</td>
</tr>
<tr>
<td>Fourth Fifth</td>
<td>$65,000-$98,200</td>
</tr>
<tr>
<td>Top Fifth</td>
<td>$98,200 and over</td>
</tr>
<tr>
<td>Top 5 percent</td>
<td>$170,082 and over</td>
</tr>
</tbody>
</table>

Source: U.S. Bureau of the Census.

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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.
- 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. As a result, human capital, especially education, has become such an important role in increasing skilled labor.

### Inequality around the World

- Answering this question is problematic.
  - Some countries, data unavailable
  - Data collected differently
    - By individual
    - By family
    - Expenditures versus income
  - Surprisingly, the US is in the middle of the pack with Brazil and S. Africa rich people possessing 30 times that of the poor.

#### Table 2: Income Inequality in the United States

<table>
<thead>
<tr>
<th>Year</th>
<th>Bottom Fifth</th>
<th>Second Fifth</th>
<th>Middle Fifth</th>
<th>Fourth Fifth</th>
<th>Top Fifth</th>
<th>Top 5%</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>4.1%</td>
<td>9.6%</td>
<td>15.5%</td>
<td>23.2%</td>
<td>47.6%</td>
<td>20.5%</td>
</tr>
<tr>
<td>2000</td>
<td>4.3%</td>
<td>9.8%</td>
<td>15.5%</td>
<td>22.2%</td>
<td>47.4%</td>
<td>20.8%</td>
</tr>
<tr>
<td>1990</td>
<td>4.4%</td>
<td>10.8%</td>
<td>16.6%</td>
<td>23.8%</td>
<td>44.3%</td>
<td>17.4%</td>
</tr>
<tr>
<td>1980</td>
<td>5.2%</td>
<td>11.5%</td>
<td>17.3%</td>
<td>24.3%</td>
<td>41.5%</td>
<td>15.3%</td>
</tr>
<tr>
<td>1970</td>
<td>5.5%</td>
<td>12.2%</td>
<td>17.6%</td>
<td>23.8%</td>
<td>40.9%</td>
<td>15.6%</td>
</tr>
<tr>
<td>1960</td>
<td>4.8%</td>
<td>12.2%</td>
<td>17.8%</td>
<td>24.0%</td>
<td>41.3%</td>
<td>15.9%</td>
</tr>
<tr>
<td>1950</td>
<td>4.5%</td>
<td>12.0%</td>
<td>17.4%</td>
<td>23.4%</td>
<td>42.7%</td>
<td>17.3%</td>
</tr>
<tr>
<td>1945</td>
<td>4.1%</td>
<td>9.2%</td>
<td>14.1%</td>
<td>20.9%</td>
<td>51.7%</td>
<td>26.5%</td>
</tr>
</tbody>
</table>

*Source: U.S. Bureau of the Census.*

#### Table 3: Inequality around the World

<table>
<thead>
<tr>
<th>Country</th>
<th>Lowest 20 Percent</th>
<th>Highest 20 Percent</th>
<th>Gap between Rich and Poor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japan</td>
<td>10.6</td>
<td>35.7</td>
<td>3.4</td>
</tr>
<tr>
<td>Germany</td>
<td>8.5</td>
<td>36.9</td>
<td>4.2</td>
</tr>
<tr>
<td>India</td>
<td>8.9</td>
<td>41.4</td>
<td>4.7</td>
</tr>
<tr>
<td>Canada</td>
<td>7.0</td>
<td>40.4</td>
<td>5.8</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>6.1</td>
<td>44.0</td>
<td>7.2</td>
</tr>
<tr>
<td>United States</td>
<td>5.4</td>
<td>45.6</td>
<td>6.5</td>
</tr>
<tr>
<td>Russia</td>
<td>4.9</td>
<td>53.3</td>
<td>10.5</td>
</tr>
<tr>
<td>China</td>
<td>4.7</td>
<td>50.0</td>
<td>10.6</td>
</tr>
<tr>
<td>Nigeria</td>
<td>4.4</td>
<td>55.7</td>
<td>12.7</td>
</tr>
<tr>
<td>Mexico</td>
<td>3.1</td>
<td>59.1</td>
<td>15.1</td>
</tr>
<tr>
<td>Brazil</td>
<td>2.0</td>
<td>64.4</td>
<td>32.2</td>
</tr>
<tr>
<td>South Africa</td>
<td>2.0</td>
<td>66.5</td>
<td>33.2</td>
</tr>
</tbody>
</table>

The Poverty Rate

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

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.

Poverty does not affect all groups with equal frequency.

Table 4 Who Is Poor?

<table>
<thead>
<tr>
<th>Group</th>
<th>Poverty Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>All persons</td>
<td>12.5%</td>
</tr>
<tr>
<td>White, not Hispanic</td>
<td>8.2%</td>
</tr>
<tr>
<td>Black</td>
<td>24.4%</td>
</tr>
<tr>
<td>Hispanic</td>
<td>22.5%</td>
</tr>
<tr>
<td>Asian, Pacific Islander</td>
<td>11.8%</td>
</tr>
<tr>
<td>Children (under age 18)</td>
<td>17.6%</td>
</tr>
<tr>
<td>Elderly (over age 64)</td>
<td>10.2%</td>
</tr>
<tr>
<td>Married-couple families</td>
<td>5.4%</td>
</tr>
<tr>
<td>Female household, no spouse present</td>
<td>28.0%</td>
</tr>
</tbody>
</table>

### The Poverty Rate

**Three Facts About Poverty**
- Poverty is correlated with race: Blacks and Hispanics are about three times more likely to live in poverty than are whites.
- Poverty is correlated with age: Children more likely to be members of poor families.
- Poverty is correlated with family composition: Single parent homes are about 5 times more likely to live in poverty than a married couple.
- Among black and Hispanic children in female-headed households, about half live in poverty.

### Problems in Measuring Inequality

**Data on income distribution and the poverty rate give an incomplete picture of inequality in living standards, based on households’ annual incomes, because of the following:**
- In-kind transfers
- Economic 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.
- If in-kind transfers were included in income at their market value, the number of families in poverty would decrease about 10 percent.

### 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.
  - Standard of living in any year depends more on lifetime income than that year’s income.
Problems in Measuring Inequality

• Transitory versus Permanent Income
  • Incomes vary because of random and transitory forces.
    • 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

• People sometimes speak of “the rich” and “the poor” as if these groups consisted of the same families from year to year. This is not the case…
• The movement of people among income classes is called 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.
• Skip p. 439 through the middle of p. 442.

GOVERNMENT POLICIES TO REDUCE POVERTY

• According to a popular metaphor, the government should provide a “safety net” to prevent any citizen from falling too far.
  – 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.
• The magnitude of the effects of the minimum wage depends on the elasticity of the demand for labor.
• 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)
  - Critics: creates incentive problems…

Negative Income Tax

- A negative income tax collects tax revenue from high-income households and gives transfers to low-income households.
- High-income families would pay a tax based on their incomes. Low-income families would receive a subsidy—a “negative tax.”
  \[ \text{Taxes owed} = \left( \frac{1}{3} \text{ of income} \right) - \$10,000 \]
- 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.
- Advocates of in-kind transfers argue that such transfers ensure that the poor get what they most need. Participants can only buy food, not alcohol or other harmful additions.
- Advocates of cash payments argue that in-kind transfers are inefficient and disrespectful. In other words, the government does not know what good and services the poor need most.

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.
- An antipoverty program can affect work incentives:
  - A family needs $15,000 to maintain a reasonable standard of living.
  - This sometimes discourages working because if someone earns just above $15,000, they would earn less than what the government would supplement.
- Workfare refers to a system that would require any person collecting benefits to accept a government job.
- A 1996 welfare reform bill advocated providing benefits for only a limited period of time, 5-years.
  - Bill Clinton stated, “Welfare should be a second chance, not a way of life.”