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PRINCIPLES OF

ECONOMICS

Eighth Edition



CHAPTER

20

Income Inequality and Poverty

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Look for the answers to these questions:

- How much inequality and poverty exist in our society?
- 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

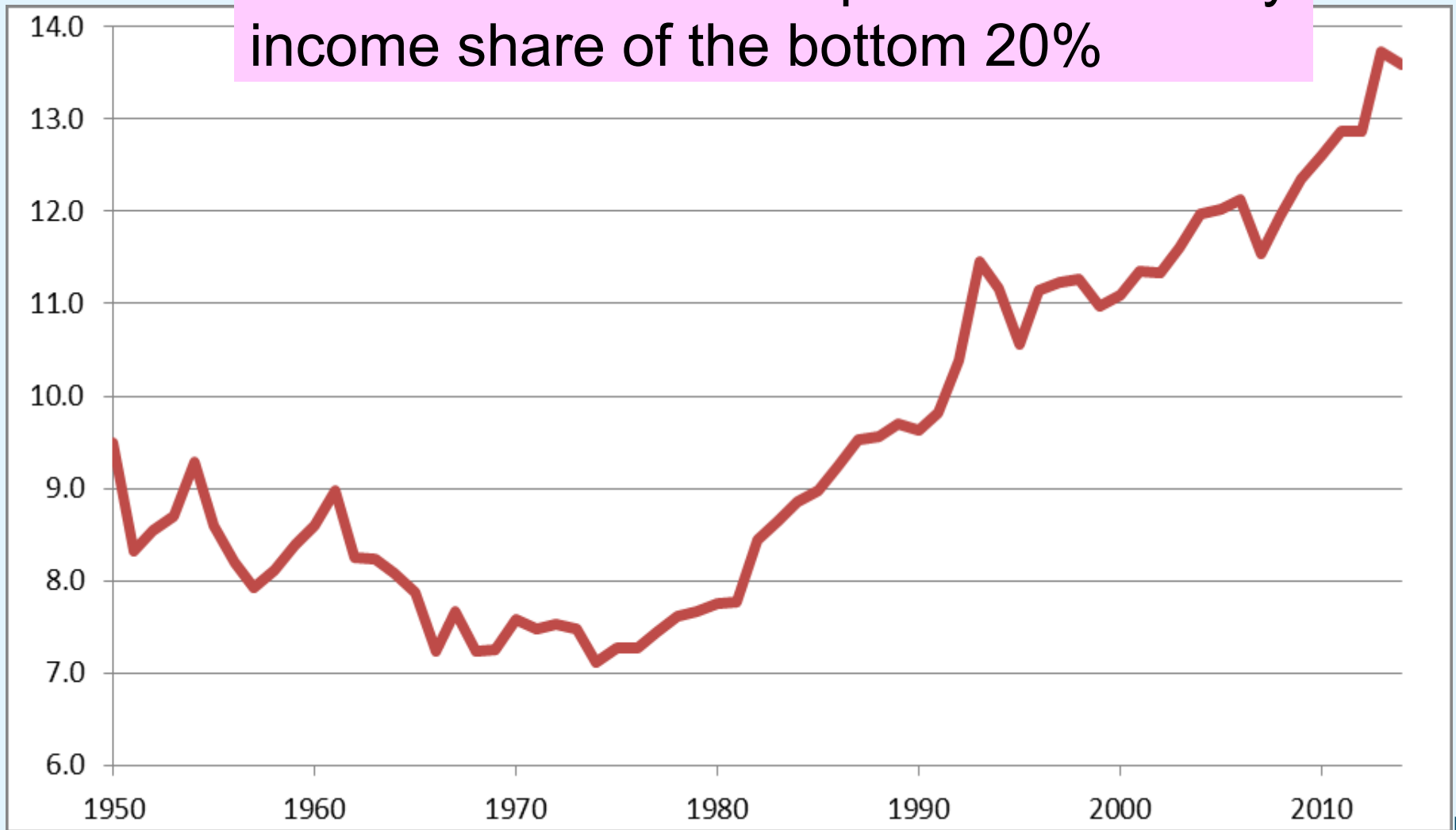
- In the absence of discrimination
 - The income distribution in a market economy may not be equitable or otherwise desirable.
- In this chapter, we examine:
 - Indicators of inequality and poverty
 - Philosophies about income redistribution
 - Policies designed to help the poor

The U.S. Income Distribution: 2014

Group	Annual household income
Bottom quintile	Under \$21,430
Second quintile	\$21,430– \$41,166
Middle quintile	\$41,167 – \$68,199
Fourth quintile	\$68,200 – \$112,253
Top quintile	\$112,254 and over
Top 5 percent	\$206,563 and over

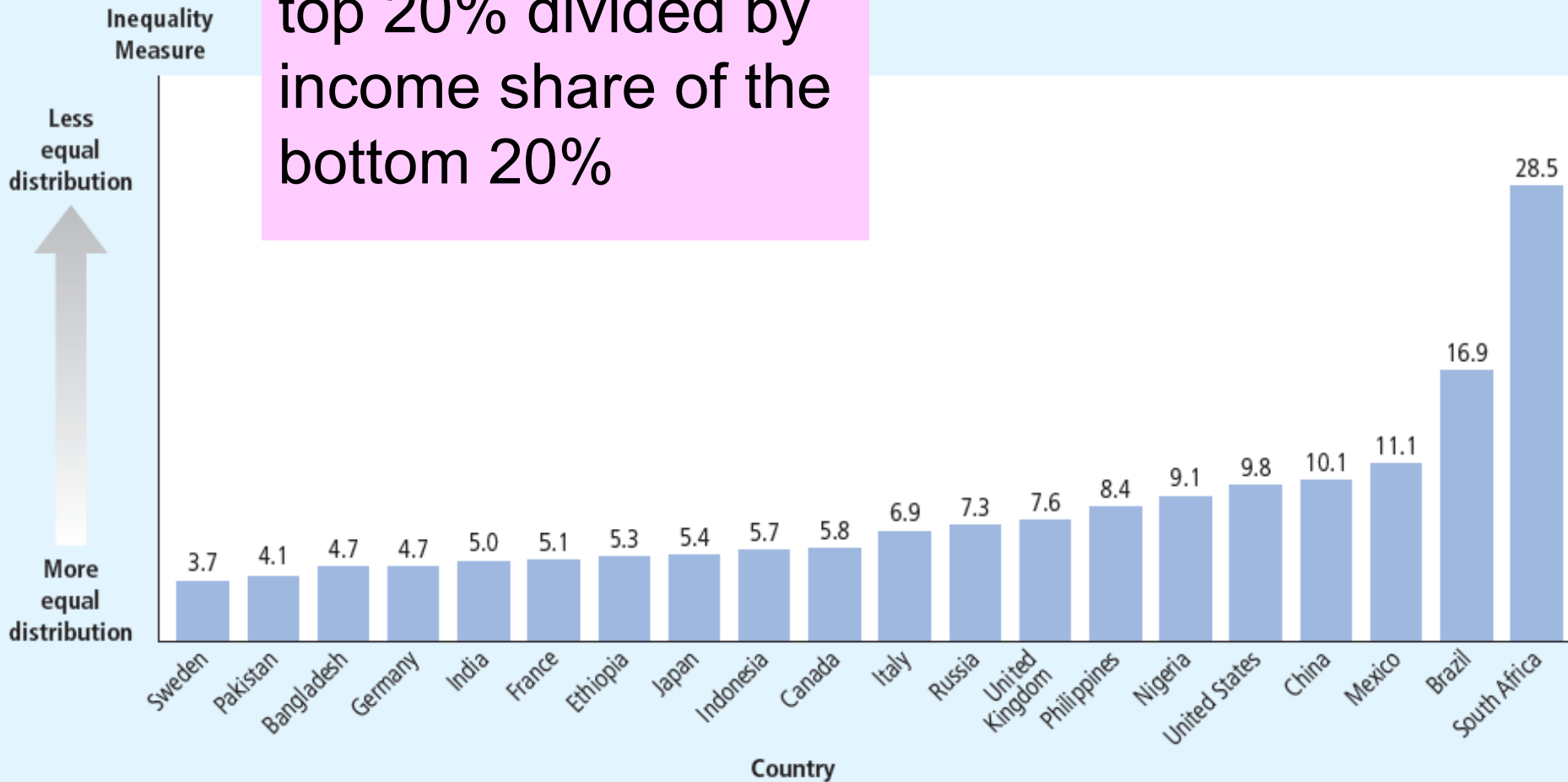
U.S. Income Inequality, 1950–2014

Income share of the top 20% divided by income share of the bottom 20%



Inequality around the World

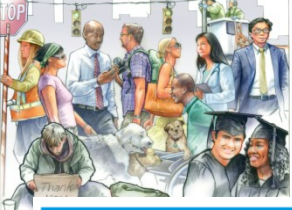
Income share of the top 20% divided by income share of the bottom 20%





Poverty

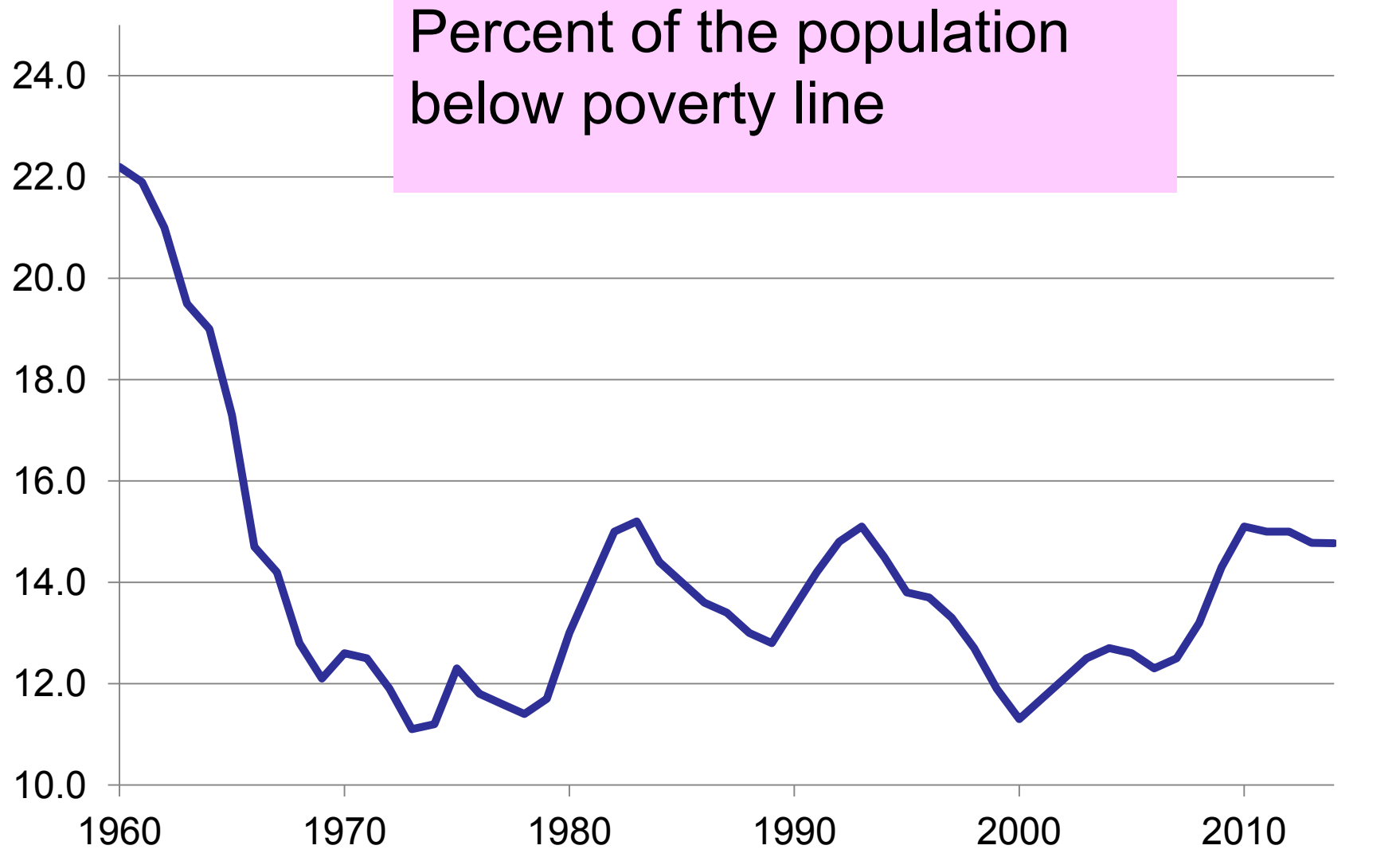
- **Poverty rate**
 - Percentage of the population whose family income falls below an absolute level (poverty line)
- **Poverty line**
 - Set by the federal government (three times cost of providing an adequate diet)
 - Depends on family size
 - Adjusted every year to account for changes in the level of prices



Poverty

- In 2014 in the U.S.,
 - Median family income = \$66,632
 - Poverty line for family of four = \$24,418
 - Poverty rate = 14.8%

U.S. Poverty Over Time



U.S. Poverty Rate by Group, 2012

Group	Poverty Rate
All persons	14.8%
White, not Hispanic	10.1
Black	26.2
Hispanic	23.6
Asian	12.0
Children	21.1
Elderly	10.0
Married-couple families	6.2
Female household, no spouse present	33.1



Problems in Measuring Inequality

- Data on income distribution & poverty rate
 - Incomplete picture of inequality
 - Household annual income
 1. Doesn't account for in-kind transfers
 - Transfers to the poor in the form of goods and services rather than cash



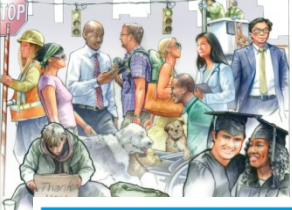
Problems in Measuring Inequality

- Data on income distribution & poverty rate
 2. Normal life cycle pattern
 - Causes inequality in the distribution of annual income
 - May not represent true inequality in living standards
 - Life cycle: 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).



Problems in Measuring Inequality

- Data on income distribution & poverty rate
 3. Transitory vs. permanent income
 - Transitory changes - need not affect standard of living
 - A family's ability to buy goods and services depends largely on its permanent income
 - Permanent income: a person's normal income



Economic Mobility

- Economic mobility
 - Many people move among income classes
 - Some reflects transitory variation in income
 - Some reflects more persistent changes in income
 - Many of those below the poverty line are there only temporarily



Political Philosophy

- What should the government do about economic inequality?
- Political philosophies of redistributing income
 - Utilitarianism
 - Liberalism
 - Libertarianism



Utilitarianism

- **Utility:**
 - A measure of happiness or satisfaction
- **Utilitarianism:**
 - Government should choose policies to maximize society's total utility
 - Founders: Jeremy Bentham, John Stuart Mill



Utilitarianism

- Because of diminishing marginal utility
 - 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:
 - Government should choose policies deemed to be just by an impartial observer behind a “veil of ignorance.”
 - Founder: John Rawls
- Maximin criterion:
 - Government should aim to maximize the well-being of society’s worst-off person



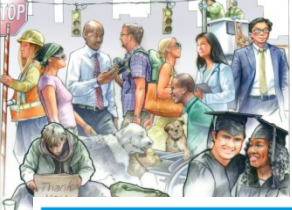
Liberalism

- Liberalism:
 - Calls for more redistribution than utilitarianism (though still not complete equalization of incomes).
 - Income redistribution is a form of social insurance, a government policy aimed at protecting people against the risk of adverse events.



Libertarianism

- **Libertarianism:**
 - Government should punish crimes and enforce voluntary agreements but not redistribute income
 - Advocate: Robert Nozick
 - Libertarians focus on the process not outcome:
 - Government should enforce individual rights, should try to equalize opportunities.
 - If the income distribution is achieved fairly, government 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 government should provide a “safety net.”
- We now consider a few such policies...



1. Minimum-Wage Laws

- Arguments for:
 - Helps the poor without any cost to government
 - 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

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



3. Negative Income Tax

- Negative income tax:
 - Tax system that collects revenue from high-income households and gives transfers to low-income households
- The Earned Income Tax Credit (EITC)
 - Is similar to a negative income tax.



4. In-Kind Transfers

- In-kind transfers: goods or services provided to the needy
 - Examples: homeless shelters, soup kitchens
 - Supplemental Nutrition Assistance Program (SNAP): Gives low-income families a plastic card that can be used to buy food at stores
 - Medicaid, government-provided healthcare for the poor
- An alternative: cash payments
 - People - 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 100% in some cases!).
 - Such policies therefore discourage the poor from escaping poverty on their own.
- One possible solution: “Workfare,”
 - System requiring people to accept government jobs while collecting benefits.



Conclusion

- Poverty is one of society's most serious problems.
- Governments can sometimes improve market outcomes.
 - Public policy can help reduce poverty and inequality
- People face trade-offs.
 - Policies designed to improve equity often sacrifice efficiency, so the proper scope of policy is the subject of ongoing controversy

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.

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.

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.