Income Inequality and Poverty

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The Measurement of Inequality

• Questions of measurement:
  – 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?
U.S. Income Inequality

• Distribution of income
  – Align families by income
  – Divide all families into five equal groups
    • Same number of families in each group
    • Different incomes
      – Bottom fifth: 4% of all income
      – Top fifth: 47.8% of all income

“As far as I’m concerned, they can do what they want with the minimum wage, just as long as they keep their hands off the maximum wage.”
Table 1
The Distribution of Income in the United States: 2011

<table>
<thead>
<tr>
<th>Group</th>
<th>Annual Family Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bottom Fifth</td>
<td>Under $27,218</td>
</tr>
<tr>
<td>Second Fifth</td>
<td>$27,218 – $48,502</td>
</tr>
<tr>
<td>Middle Fifth</td>
<td>$48,502 – $75,000</td>
</tr>
<tr>
<td>Fourth Fifth</td>
<td>$75,000 – $115,866</td>
</tr>
<tr>
<td>Top Fifth</td>
<td>$115,866 and over</td>
</tr>
<tr>
<td>Top 5 percent</td>
<td>$205,200 and over</td>
</tr>
</tbody>
</table>

Source: U.S. Bureau of the Census.
U.S. Income Inequality

• **Trends in income distribution**
  – 1935-1970: more equal distribution
  – 1970-2011: more unequal distribution

• **Causes:**
  – Increase in international trade with low-wage countries
  – Changes in technology

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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>2011</td>
<td>3.8%</td>
<td>9.3%</td>
<td>15.1%</td>
<td>23.0%</td>
<td>48.9%</td>
<td>21.3%</td>
</tr>
<tr>
<td>2010</td>
<td>3.8</td>
<td>9.5</td>
<td>15.4</td>
<td>23.5</td>
<td>48.8</td>
<td>20.0</td>
</tr>
<tr>
<td>2000</td>
<td>4.3</td>
<td>9.8</td>
<td>15.5</td>
<td>22.8</td>
<td>47.4</td>
<td>20.8</td>
</tr>
<tr>
<td>1990</td>
<td>4.6</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>17.5</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>1935</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.

This table shows the percentage of total before-tax income received by families in each fifth of the income distribution and by those families in the top 5 percent.
Inequality Around the World

• Inequality measure
  – Ratio of the income received by the richest tenth of the population
  – To the income of the poorest tenth

• Degree of inequality
  – Varies substantially around the world
This figure shows a measure of inequality: the income (or expenditure) of the richest 20% of the population divided by the income (or expenditure) of the poorest 20%. Among these nations, Japan and Ethiopia have the most equal distribution of economic well-being, while South Africa and Brazil have the least equal.
The Poverty Rate

• Poverty rate
  – Percentage of the population
  – Whose family income
    • Falls below an absolute level (poverty line)

• Poverty line
  – An absolute level of income
    • Set by the federal government for each family size
    • Below which a family is deemed to be in poverty
The poverty rate shows the percentage of the population with incomes below an absolute level called the poverty line.
The Poverty Rate

• 2011, the U.S.
  – Median family - income of $60,974
  – Poverty line for a family of four: $23,021
  – Poverty rate: 15%

• Poverty rate
  – 1959: 22.4%
  – 1973: 11.1%, lowest to date
The Poverty Rate

- Poverty - economic malady
  - Affects all groups within the population
    - Not with equal frequency
- Poverty and race
  - Blacks and Hispanics
    - Three times more likely to live in poverty than whites
Table 3

Who Is Poor?

<table>
<thead>
<tr>
<th>Group</th>
<th>Poverty Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>All persons</td>
<td>15.0%</td>
</tr>
<tr>
<td>White, not Hispanic</td>
<td>9.8</td>
</tr>
<tr>
<td>Black</td>
<td>27.6</td>
</tr>
<tr>
<td>Hispanic</td>
<td>25.3</td>
</tr>
<tr>
<td>Asian</td>
<td>12.3</td>
</tr>
<tr>
<td>Children (under age 18)</td>
<td>21.9</td>
</tr>
<tr>
<td>Elderly (over age 64)</td>
<td>8.7</td>
</tr>
<tr>
<td>Married-couple families</td>
<td>6.2</td>
</tr>
<tr>
<td>Female household, no spouse present</td>
<td>31.2</td>
</tr>
</tbody>
</table>

*Source: U.S. Bureau of the Census. Data are for 2011.*

This table shows that the poverty rate varies greatly among different groups within the population.
The Poverty Rate

• Poverty and age
  – Children - more likely to be members of poor families
  – The elderly - less likely to be poor

• Poverty and family composition
  – Families headed by a female adult and without a spouse present
    • Five times as likely to live in poverty as a family headed by a married couple
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
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
Alternative measures of inequality

• Different measures of inequality lead to dramatically different results

• Average annual income, 2006
  – Poorest fifth of U.S. households = $9,974
  – Richest fifth of U.S. households = $149,963
    • About 15 times as much income as poorest fifth
Alternative measures of inequality

• Account for progressive taxes
  – Richest fifth
    • About 14 times as much after-tax income as poorest fifth

• Consumption
  – Richest fifth
    • 3.9 times as much as the consumption of the poorest fifth
Alternative measures of inequality

• Consumption
  – Correct for differences in number of people in household
    • Richest fifth - average of 3.1 people
    • Poorest fifth - average of 1.7 people
  – Consumption per person in the richest fifth
    • Only 2.1 times as much as consumption per person in the poorest fifth
Economic Mobility

• Economic mobility
  – Movement of people 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
Economic Mobility

- Persistence of economic success from generation to generation
  - Above-average income carries over from parents to children
- Millionaires
  - Four of five millionaires made their money on their own
  - One in five millionaires inherited their fortunes
Political Philosophy

• What should the government do about economic inequality?

• Political philosophies of redistributing income
  – Utilitarianism
  – Liberalism
  – Libertarianism
Utilitarianism

• Utilitarianism
  – Political philosophy
  – The government should choose policies to maximize the total utility of everyone in society

• Utility
  – Measure of happiness or satisfaction
Utilitarianism

• Utilitarian case for redistributing income
  – Based on diminishing marginal utility
  – One extra dollar of income
    • More utility to poor person than to rich person
  – Government: redistribution of income
    • From rich to poor to increase total utility
    • Balance the gains from greater equality against the losses from distorted incentives
    • Maximize total utility
      – Stops short of making society fully egalitarian
Liberalism

- Liberalism
  - Political philosophy
  - The government should choose policies deemed just
  - As evaluated by an impartial observer behind a “veil of ignorance”
- Society’s institutions, laws, and policies
  - Should be just
Liberalism

- **Maximin criterion**
  - Government - aim to maximize the well-being of the worst-off person in society
  - Justifies public policies aimed at equalizing the distribution of income
    - Transfers income from the rich to the poor
    - Society raises the well-being of the least fortunate
  - Wouldn't lead to a completely egalitarian society
Liberalism

• Redistribution of income
  – A form of social insurance

• Social insurance
  – Government policy
  – Aimed at protecting people against the risk of adverse events
  – Maximize the minimum utility
Libertarianism

- Political philosophy
- The government should punish crimes and enforce voluntary agreements
- Society itself earns no income
- Only individual members of society earn income
- The government should not redistribute income
Libertarianism

- Libertarianism
- Don’t evaluate economic outcomes
- Evaluate the process by which these outcomes arise
- As long as the process determining the distribution of income is just
  - The resulting distribution is fair, no matter how unequal
- Equality of opportunities is more important than equality of incomes
Policies to Reduce Poverty

• Government
  – Should provide a “safety net”

• Poverty
  – Associated with various economic and social ills
    • Homelessness, drug dependence, health problems, teenage pregnancy, illiteracy, unemployment, low educational attainment
    • More likely to commit crimes
    • More likely to be victims of crimes
Policies to Reduce Poverty

- Policies to reduce number of people living in poverty
  - Minimum-wage laws
  - Welfare
  - Negative income tax
  - In-kind transfers
Policies to Reduce Poverty

- **Minimum-wage laws**
  - Workers who remain employed
    - Benefit from higher wage
  - Higher unemployment
    - Workers who might have been employed at a lower wage - worse off
  - The magnitude of these effects
    - Elasticity of demand
Policies to Reduce Poverty

- **Welfare**
  - Government programs that supplement the incomes of the needy
    - To qualify: Low income and some additional “need”
  - Temporary Assistance for Needy Families (TANF) - assists families with children and no adult able to support the family
  - Supplemental Security Income (SSI) – assists the poor who are sick or disabled
Policies to Reduce Poverty

- Criticism of welfare programs
  - Create incentives for people to become “needy”
    - May encourage families to break up
    - May encourage illegitimate births
  - Exacerbate the very problems they are supposed to cure

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Policies to Reduce Poverty

• Negative income tax
  – Collects revenue from high-income households and gives subsidies to low-income households
  – Poor families – receive financial assistance without having to demonstrate need
  – Subsidize not only the unfortunate but also those who are simply lazy
  – Earned Income Tax Credit (EITC)
    • Applies only to the working poor
Policies to Reduce Poverty

• In-kind transfers
  – Provide poor people directly with some of the goods and services they need to raise their living standards
  – Food stamps
    • Government vouchers - used to buy food at stores
  – Healthcare: Medicaid
  – Critics: give the poor people cash
Policies to Reduce Poverty

• Antipoverty programs and work incentives
  – Many policies aimed at helping the poor have unintended effects
    • Discourage the poor from escaping poverty on their own
    • Very high effective marginal tax rates
    • Discourage families from working
Policies to Reduce Poverty

• Antipoverty programs and work incentives
  – Solution: reduce benefits more gradually as incomes rise
    • Higher cost of antipoverty programs
  – Trade-off
    • Burdening the poor with high effective marginal tax rates
    • Burdening taxpayers with costly programs to reduce poverty
Policies to Reduce Poverty

• Other ways to reduce the work disincentive of antipoverty programs:
  – Workfare
    • Require any person collecting benefits to accept a government-provided job
  – Provide benefits for only a limited period of time