

CHAPTER 20

# Income Inequality and Poverty

PRINCIPLES OF  
**Economics**  
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Premium PowerPoint Slides  
by Ron Cronovich

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**In this chapter,  
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?

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### Introduction

From the previous two chapters:

- § Equilibrium wages equal
- § 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.

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## 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

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## The U.S. Income Distribution: 2006

Group	Annual household income
Bottom fifth	Under \$20,035
Second fifth	\$20,035 – \$37,774
Middle fifth	\$37,774 – \$60,000
Fourth fifth	\$60,000 – \$97,032
Top fifth	\$97,032 and over
Top 5 percent	\$174,012 and over

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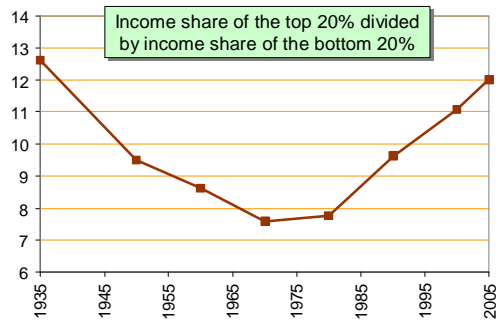
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## U.S. Inequality Over Time



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### Poverty

§ **Poverty line:**

§ **Poverty rate:**

§ In 2006 in the U.S.,

- § median family income = \$58,526
- § poverty line for family of four = \$20,614
- § poverty rate = 12.3%

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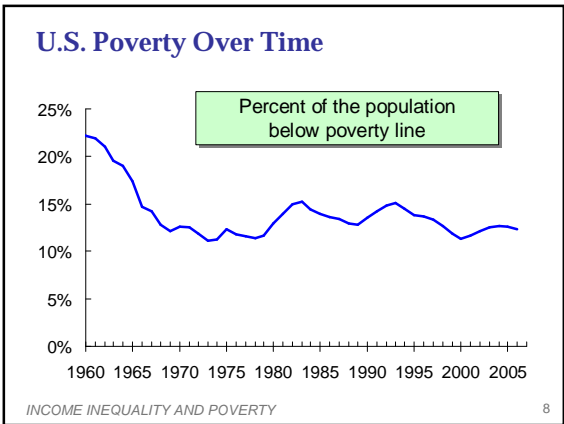
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### U.S. Poverty Rate by Group, 2006

Group	Poverty Rate
All persons	12.3%
White, not Hispanic	8.2
Black	24.3
Hispanic	20.6
Asian	10.3
Children	17.4
Elderly	9.4
Married-couple families	4.9
Female household, no spouse present	28.3

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### Problems Measuring Inequality

#### 1. In-kind transfers:

§ Omitted from measures of inequality and poverty, biasing them upward

#### 2. The Life Cycle:

§ 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.

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### 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

#### 4. Economic mobility:

§ Many people move among income classes.

§ The poverty and inequality measures discussed above do not distinguish between the temporarily poor and the persistently poor.

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## The Political Philosophy of Redistributing Income

We consider three philosophies:

- § Utilitarianism
- § Liberalism
- § Libertarianism

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## Utilitarianism

§ **Utility:**

§ **Utilitarianism:**

§ Founders: Jeremy Bentham, John Stuart Mill

§ Because of **diminishing marginal utility**, redistributing income from rich to poor

§ Yet, utilitarians do not advocate *equalizing* incomes – would reduce total income of everyone due to incentive effects and efficiency losses.

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## Liberalism

§ **Liberalism:**

§ Founder: John Rawls

§ **Maximin criterion:**

§ Calls for more redistribution than utilitarianism (though still not complete equalization of incomes).

§ Income redistribution is a form of **social insurance**.

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## Libertarianism

### § Libertarianism:

§ Advocate: Robert Nozick

§ Instead of focusing on outcomes, libertarians focus on

§ Govt should enforce

§ If the income distribution is achieved fairly, gov't

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## Policies to Reduce Poverty

§ Poor families more likely to experience

§ homelessness

§ drug dependence

§ health problems

§ teen pregnancy

§ illiteracy

§ unemployment

§ Most people believe gov't should provide a "safety net."

§ We now consider a few such policies...

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## 1. Minimum-Wage Laws

§ Arguments for:

§ Arguments against:

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## 2. Welfare

### § Welfare:

- § Temporary Assistance for Needy Families (TANF)
- § Supplemental Security Income (SSI)

§ Critics argue that such programs

§ However, the severity of such incentive problems is unknown.

§ Proponents note that inflation-adjusted welfare benefits fell as single-parent families increased.

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## 3. Negative Income Tax

### § Negative income tax:

§ Example: Taxes owed =

- § If earnings = \$90,000, taxes owed = \$20,000
- § If earnings = \$60,000, taxes owed = \$10,000
- § If earnings = \$30,000, taxes owed =
- § If earnings = \$15,000, taxes "owed" =

§ The Earned Income Tax Credit (EITC) is similar to a negative income tax.

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## 4. In-Kind Transfers

§ 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

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### Anti-Poverty Programs and Work Incentives

- § Assistance from anti-poverty programs declines as income rises.
- § The result:
  
- § Such policies therefore discourage the poor from escaping poverty on their own.
- § One possible solution:

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### 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.*

so the proper scope of policy is the subject of ongoing controversy.

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