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Income Inequality and Poverty

PRINCIPLES OF

MICROECONOMICS

FOURTH CANADIAN EDITION

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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?
- 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

Recap of the previous two chapters:

- 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

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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.
- The invisible hand acts to allocate resources efficiently, but it does not necessarily ensure that resources are allocated fairly.
- 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 Measurement of Inequality

- The four 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?

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**TABLE 20.1: Distribution of Market Income in Canada, 2003**

Group	Average Annual Family Income in Group	% of Total Canadian Market Income
Bottom fifth	\$ 5 700	2%
Second fifth	19 500	8
Middle fifth	38 200	15
Fourth fifth	63 300	24
Top fifth	131 800	51

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### Case Study: Income Redistribution in Canada

Group	Average Family Market Income	Average Transfers Received	Average Income Taxes Paid	Average Income after Transfers and Taxes
Bottom fifth	\$ 5 700 (2%)	\$7 000 (20%)	\$ 600 (1.2%)	\$ 12 100 (5%)
Second fifth	19 500 (8)	9 100 (26.1)	2 600 (5.1)	26 000 (11)
Middle fifth	38 200 (15)	7 800 (22.5)	6 100 (12)	39 900 (16)
Fourth fifth	63 300 (24)	6 400 (18.5)	11 400 (22.2)	58 300 (24)
Top fifth	131 800 (51)	4 500 (12.9)	30 500 (59.5)	105 800 (44)
Average all groups	51 700	7 000	10 300	48 400

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TABLE 20.3: Inequality Around the World

Country	Lowest 20 Percent	Highest 20 Percent	Ratio: Gap between Rich and Poor
Japan	10.6%	35.7%	3.4
Germany	8.5	36.9	4.3
India	8.9	41.6	4.7
Canada	7.0	40.4	5.8
United Kingdom	6.1	44.0	7.2
United States	5.4	45.8	8.5
Russia	4.9	51.3	10.5
China	4.7	50.0	10.6
Nigeria	4.4	55.7	12.7
Mexico	3.1	59.1	19.1
Brazil	2.0	64.4	32.2
South Africa	2.0	66.5	33.2

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### Poverty

- **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.
- **Poverty rate:** the percentage of the population whose family income falls below the poverty line.
- Canada, like most countries except the U.S., does not have an official measure of the poverty line.

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## Poverty

- **Low-income cutoff (LICO):** It is the level of income at which a household of a given size in a community with a given population spends 20 percent more than average on food, shelter, and clothing.
- Canadian families spend an average of about 43 percent of their income on these three goods.
- Families that spend more than 63 percent of their income on food, shelter, and clothing fall under the LICO.
- The poverty rate in Canada using the LICO approach was 15.5 percent.

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## Poverty

- Problem with LICO as a measure of poverty is that it is a "relative" measure that is defined in relation to average income.
  - A country can have a great deal of income inequality but not have anyone living in poverty. Canadian families spend an average of about 43 percent of their income on these three goods.
- To overcome limitations of relative measures such as the LICO, some people advocate the use of an "absolute" measure of the poverty line (i.e., the cost of acquiring basic needs).
  - This list of basic needs is however somewhat subjective.

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## Problems Measuring Inequality

1. **In-kind transfers:** assistance that takes the form of goods and services rather than cash.
  - Omitted from measures of inequality and poverty, biasing them upward
2. **The Life Cycle:** 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.

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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 **permanent income**, a person's normal income.

#### 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:** 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
- 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.

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### Liberalism

- **Liberalism:** argues that govt should choose policies deemed to be just by an impartial observer behind a “veil of ignorance”
  - Founder: John Rawls
- **Maximin criterion:** 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.

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### Libertarianism

- **Libertarianism:** argues that govt should punish crimes and enforce voluntary agreements but not redistribute income
  - Advocate: Robert Nozick
- Instead of focusing on outcomes, libertarians focus on the process.
  - Govt should enforce individual rights, should try to equalize opportunities.
  - If the income distribution is achieved fairly, govt should not interfere, even if unequal.

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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 govt should provide a “safety net.”
- We now consider a few such policies...

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## 1. Minimum-Wage Laws

- 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.

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## 2. Welfare

- **Welfare:** govt programs that supplement the incomes of the needy
- In Canada, welfare programs are the responsibility of provincial governments.
- Most welfare programs in Canada distinguish people that are employable and those that are not. The former receive lower benefits compared to the latter.
- Critics argue that such programs reduce the incentive to work.

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## 3. Negative Income Tax

- **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 (i.e., a subsidy).

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#### 4. In-Kind Transfers

- In-kind transfers are goods or services provided to the needy. Examples:
  - Subsidized housing
  - Subsidized daycare
- Advocates argue that with in-kind transfers, the needy get what they need.
- In contrast, some view cash payments as a better approach because in-kind transfers are inefficient and disrespectful.

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#### 5. Employment Insurance

- EI is available to workers who lose their jobs through no fault of their own.
- Should the EI system be organized along the principles of an insurance program or along the lines of an income-transfer program?
  - The payroll tax is the same for all industries regardless of the risk of being laid-off for a particular industry or occupation.
  - The EI system provides an implicit wage subsidy to industries that employ workers with a high risk of unemployment.

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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.*  
Policies designed to improve equity often sacrifice efficiency, so the proper scope of policy is the subject of ongoing controversy. 

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## 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.

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## 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.

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## CHAPTER SUMMARY

- Policies such as welfare, minimum-wage laws, negative income taxes, in-kind transfers, and employment insurance 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.

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# End: Chapter 20

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