

MODULE 78 / 42: INCOME INEQUALITY AND INCOME DISTRIBUTION

The purpose of this module is to learn how poverty is defined in the U.S., who falls into poverty, what causes poverty, and the consequences of poverty. The module also discusses income inequality and how antipoverty programs in the U.S. address poverty and the distribution of income.

Student learning objectives:

- What defines poverty, what causes poverty, and the consequences of poverty.
- How income inequality is measured, and how it has changed over time in America. How programs like Social Security affect poverty and income inequality.

Key Economic Concepts For This Module:

- Minority groups and single-mothers are disproportionately more likely to fall into poverty than the rest of the U.S. population.
- Some of the most damaging long-term consequences of poverty are the impacts of poor health and educational opportunities on children living in poverty.
- The distribution of income in the U.S. is unequal, but without the system of taxes and transfer payments it would be even more unequal.
- Some economists and politicians argue that welfare payments create inefficiencies because they may lessen work incentives and productivity. This debate boils down to weighing the relative merits of equity versus efficiency.

Common Student Difficulties:

- Depending upon the school district, the topic of poverty may be quite familiar or a concept reserved only for developing nations. The material in this module isn't difficult, but it is a topic that can be a political minefield because of the normative nature of the debate. The instructor might need to think about where s/he wishes the discussion to go and what the students need to hear. If the class, and local community, seems to be fairly homogenous and of similar attitudes on these topics, the instructor might wish to present facts and theories that support alternative arguments and views of the world.

In-Class Presentation of Module and Sample Lecture

Suggested time: This module can be covered in a one-hour class session.

- I. The Problem of Poverty
 - A. Trends in Poverty
 - B. Who Are the Poor?
 - C. What Causes Poverty?
 - D. Consequences of Poverty
- II. Economic Inequality
- III. Economic Insecurity
- IV. U.S. Antipoverty Programs
 - A. Means-Tested Programs
 - B. Social Security and Unemployment Insurance
 - C. The Effects of Programs on Poverty and Inequality
- V. The Debate Over Income Redistribution
 - A. Problems with Income Redistribution
 - B. The Politics of Income Redistribution

I. The Problem of Poverty

Note: Before starting this module, it might be interesting to do the exercise provided.

The definition of poverty is arbitrary, though the government has tried to improve the statistical measures since the first definition of poverty was created in the 1960s. If a person or household falls below a specific “poverty line”, they are considered part of the population living in poverty. In other words, the government would consider them officially “poor”.

Note: There are many good resources out there, but the University of Wisconsin-Madison has an Institute for Research on Poverty with a good website. Here, students can learn about how the U.S. government defines poverty, how the poverty line was first developed, and how economists have attempted to improve the measure. There are also links to data and current research.

<http://www.irp.wisc.edu/faqs/faq2.htm>

A. Trends in Poverty

The percentage of Americans living in poverty rises and falls with the business cycle. Figure 78.1 shows this trend since the 1970s. During recessions, the poverty rate rises, and during recoveries the poverty rate falls.

It may be surprising to students that there is no long-term decline in U.S. poverty rates. The text makes the interesting note that the poverty rate is higher in 2009 than it was in 1973.

B. Who Are the Poor?

Poverty is not spread evenly across the population. If it was, in 2009 we would expect the same poverty rate for whites, African-Americans, Hispanics, men and women.

For example, in 2009 14.3% of Americans lived in poverty, but that rate was 25.9% for African-Americans and 25.3% of Hispanics. These two groups are overrepresented in the poverty ranks.

Single mothers are also much more likely to be in poverty than the average American, with a poverty rate of 32.5%.

The statistics also pretty clearly indicate that if a person does not have full-time work, they are more likely to be living in poverty. Only 3.6% of full-time workers were poor in 2008. However, 87.3% of

adults who worked part-time or not at all were likely to be poor. Because part-time workers usually receive lower wages and fewer benefits, they find themselves members of the “working poor”. Economists have found some evidence that this group of Americans is growing.

C. What Causes Poverty?

Anything that creates a barrier to a full-time job earning a decent wage is a cause of poverty.

Some examples:

- Educational attainment or opportunity or quality.
- Language barriers.
- Discrimination.
- Bad luck.

D. Consequences of Poverty

- About 17% of children in America are living in poverty.
- Because poverty is associated with poor health and less frequent health care, children in poverty can suffer long-term health effects and learning disabilities.
- Children with poor health and learning disabilities usually find completion of college to be more difficult and thus avenues for college degrees and high wages are closed.

II. Economic Inequality

While America is a rich country, the income is not distributed equally across the population. This explains why a rich country can still have many people living in poverty.

Suppose the population was divided into fifths, or quintiles. An equal distribution of income would look like the third column in the table below. The actual 2008 distribution of income is in the fourth column and also seen in Table 78.2

Income group	Average 2008 income	% of total income if distributed equally	2008 % of total income
Bottom quintile	\$11,656	20%	3.4%
Second quintile	\$29,517	20%	8.6%
Third quintile	\$50,132	20%	14.7%
Fourth quintile	\$79,760	20%	23.3%
Top quintile	\$171,057	20%	50%

This table tells us that the bottom 20% of the population earns far less than 20% of the total income in the U.S. And the top 20% of the population earns far more than 20% of the total income.

In fact, Table 78.2 shows that the top 5% of Americans account for 21.5% of all of the income earned in the U.S. The U.S. is therefore an example of an unequal distribution of income.

Note: this does not mean that this distribution is “bad” or “unjust” or “good” or “fair”, or anything like that. It is simply a presentation of the facts and compared to the hypothetical equal distribution.

A country’s level of income inequality can be measured with a statistic known as a *Gini coefficient*.

If a Gini = 0, the income is distributed equally like the third column of the table above.

If the Gini =1, all of the income goes to one person. This is as unequal as it gets!

The Gini in the U.S. is .468, which is high when compared to other wealthy nations in Europe, Australia or Canada. There is greater income inequality in South America and parts of Africa and Asia.

III. Economic Insecurity

Suppose one adult in the household lost a job or someone got very sick and there was no health insurance. These events could put a family that was once safely above the poverty line into poverty. Because these uncertain events can cause any family to have economic insecurity, we have a welfare state to provide temporary assistance.

IV. U.S. Antipoverty Programs

The U.S. has developed programs that are means-tested and non-means tested. A program is means-tested if it is available only to those with limited means, the poor. A non-means tested program is available to anyone regardless of income.

The U.S. also separates programs on the basis of whether the program provides monetary benefits to recipients or in-kind benefits. An in-kind benefit is a good or service, rather than cash.

Table 78.3 summarizes the major antipoverty programs in the U.S. It is clear that Medicare and Medicaid, both government health-care programs, are the largest expenditures.

A. Means-Tested Programs

A means-tested program is simple. The government establishes criteria, like a level of income, and if you earn less than this amount, you qualify for benefits. These are the classic welfare programs that most developed nations use to alleviate poverty.

In the U.S., the high-profile welfare programs are Temporary Assistance for Needy Families (TANF), food stamps and Medicaid.

The Earned Income Tax Credit (EITC) is like a negative tax. If a low-income worker is earning money at a job, rather than paying taxes to the government, he/she receives a subsidy which adds to the wages from the job.

B. Social Security and Unemployment Insurance

Note: A good history of Social Security can be found here.
<http://ssa.gov/history/hfaq.html>

High-profile programs that are non-means tested include Social Security and Unemployment Insurance. Social Security was designed to guarantee retirement income for senior citizens, but also includes payments for disabled workers and survivors of working adults who die.

Social Security is funded by a small tax on wages and benefits depend upon how much taxable income a person earned in his/her lifetime.

Unemployment insurance is funded by a small tax on employers and if a worker loses her job, she may receive monthly payments up to about 35% of her previous salary. These payments can be received for 26 weeks, unless Congress increases the benefits during particularly nasty recessions.

C. The Effects of Programs on Poverty and Inequality

The idea behind progressive income taxes and a welfare system is two-fold.

1. Those with the highest incomes pay larger shares of income taxes.
2. The poor receive transfer payments as welfare benefits.

This is typical income redistribution: the rich pay more in taxes and the poor receive transfer payments. Ideally, this should help to make the income distribution more equal than it would be in the absence of such a system.

Have they been successful?

Table 78.4 shows estimates that indicate that the poverty rate for all groups would have been much higher in the absence of the progressive taxes and transfers in the U.S.

Table 78.5 shows that the income distribution would have been more unequal if our taxes and transfers programs did not exist.

V. The Debate Over Income Redistribution

Most people agree that senior citizens, the disabled, and the poor should have some sort of economic safety net. The big debates are centered on how big the welfare system should be and who should receive benefits and for how long.

A. Problems with Income Redistribution

There are two main arguments against income redistribution.

1. Some have the philosophical belief that this is simply not the role of the government.
2. Higher tax rates to fund more welfare programs may cost the nation in terms of efficiency. In other words, more equity comes at a cost of less efficiency.

How could we address the second argument? Make the welfare programs more cost-effective (eliminate waste and fraud) and provide the benefits only to those who truly need them.

A strict means-test for welfare benefits can create a unique problem known as the “notch”.

- For example, suppose a single-mother earns \$5000 of welfare benefits if her income is below \$15,000 and zero benefits if she earns more than \$15,000.
- Suppose she has earned \$14,900 from her wages and \$5000 from her benefits. Total income = \$19,900.
- If she can work a few more hours and earn another \$1000 from her wages, she will lose the \$5000 in benefits. Total income = \$15,900. This serves as a disincentive to working harder and so the economy loses some efficiency.
- The notch can be avoided if benefits are gradually phased out as more income is earned from work.

B. The Politics of Income Redistribution

Some of the political controversy over the welfare state involves differences in opinion about the trade-offs we have just discussed: if you believe that the disincentive effects of generous benefits and high taxes are very large, you’re likely to look less favorably on welfare state programs than if you believe they’re fairly small. Economic analysis, by improving our knowledge of the facts, can help resolve some of these differences. To an important extent, however, differences of opinion on income redistribution reflect differences in values and philosophy. And those are differences economics can’t resolve.

In-Class Activities and Demonstrations

A Poverty Simulation

This online simulation centers around a poor Haitian family but the issues of education, health, work and economic insecurity are appropriate topics for those in poverty in the U.S. Give the students the website link and ask them to play the game at least once to see if they can keep their family alive. It's not easy!

<http://ayiti.newzcrew.org/globalkids/>

Discuss what strategies seemed to work best, or failed miserably. For example, if one of the children caught a cold, was it a good decision to pull them out of school to rest? Should scarce money have been sent to send them to the doctor? Should one child have the opportunity for school while the others work to pay for their sibling's education?