

## How to Study for Class 19    Inequality and Poverty

Class 19 concludes the analysis of labor markets. It examines the distribution of income, the sources of great wealth, and poverty. It also examines some of the programs in America to aid the poor.

1. Begin by looking over the Objectives listed below. This will tell you the main points you should be looking for as you read the chapter.
2. New words or definitions and certain key points are highlighted in red color in the text. Other key points are highlighted in bold type and in blue color.
3. You will be given an In Class Assignment and a Homework assignment to illustrate the main concepts of this chapter.
4. There are a few new words in this chapter. Be sure to spend time on the various definitions. There are no new graphs.
5. The teacher will focus on the main technical parts of this chapter. You are also responsible for the cases and the ways by which each case illustrates a main principle.
6. When you have finished the text, the Test Your Understanding questions, and the assignments, go back to the Objectives. See if you can answer the questions without looking back at the text. If not, go back and re-read that part of the text. When you are ready, take the Practice Quiz.

## Objectives for Class 19    Inequality and Poverty

At the end of Class 19, you will be able to answer the following questions:

1. Describe the distribution of income in the United States. How has it changed over time? How does it compare to other countries? How does it compare to the distribution of wealth?
2. What are the effects of taxes and transfers on the distribution of income in the United States?
3. Explain why the distribution of income has become more unequal since the mid-1970s.
4. What arguments are made for or against the idea that equality should be promoted by government policies?
5. How were the great fortunes created?
6. Explain how it has been argued that a “winner-takes-all” society may generate market failure.
7. How is poverty measured? What is "**absolute poverty**"? What is "**relative poverty**"? How many people are officially poor?
8. What criticisms are made of the poverty measure?
11. What has been the trend of the official poverty rate over the past three decades?
12. Describe the composition of the poor by ethnicity, by age, and by family structure. Is poverty permanent or transitory for these people?
13. Describe the main public assistance programs in the United States?
14. What criticisms have been made of the Aid to Families with Dependent Children (AFDC) program?
15. Describe the welfare reforms of 1996.

## **Class 19      Inequality And Poverty** (latest revision September 2004)

### **1. The Distribution of Income**

At the beginning of this course, we named three questions that every society must answer. One of these questions was “for whom is production taking place?”. Who gets the goods and services that are produced is determined by people’s incomes. In earlier chapters, we examined the factors that determine people’s incomes in a market economy --- both wages and profits. Now, let us see how these incomes are actually distributed in the United States.

The most common portrayal of the distribution of income is to imagine that we could line up every household in the country according to income. At one end of the line is the household with the lowest income. At the other end of the line is the household with the highest income. Households stand in the line in order of their income. Then, assume that we divide the line into five equal parts (called **quintiles**). The question that is asked is: “what percent of all of the income was earned by the households in that quintile? **For 2002, the answer is that the lowest quintile (those 20% of people with the lowest incomes) earned only 3.5% of all of the income earned. The second quintile earned 8.8% of all of the income earned. The third quintile earned 14.8% of all of the income earned. The fourth quintile earned 23.3% of all of the income earned while the top quintile earned 49.7%.** Therefore, the top 20% of income earners earned almost as much income in 2002 than the other 80%. A Dutch economist once tried to put this into human perspective. He imagined that the person with the median income (the income so that half of households earn more and half of households earn less) could be stretched or shrunk to be the average size (about 5’ 6”). Then everyone else would be stretched or shrunk so that their size related to the average size as their income relates to the median income. How tall would each person be? A widow collecting full social security benefits would be about 1’ 10”. A woman with two children collecting full welfare benefits in California would be about 11”. The person on General Relief would be much less than this. So, if you can imagine someone 5’ 6” looking down on these people, you get a sense of the disparity. On the other hand, the person with the median income would have to look up to the person with the highest income. This person would be nearly 25,000 feet tall --- 25 times the height of the Empire State Building in New York.

Let us put some perspective on these numbers. What do we mean by “rich”? If I tell you I earned \$1,000,000 this year, would you call me “rich”? The answer is probably “yes”. What about \$500,000? \$250,000? \$150,000? \$100,000? \$75,000? \$50,000? If you are like most people, you start to waver at around \$150,000. Most people say that people earning less than \$100,000 to \$150,000 are not “rich”. In fact, these people tend to call themselves “middle class”. At \$150,000 of income, people tend to differ with some saying they are “rich” while others say they are not. At \$250,000 of income, most people say they are indeed “rich”. Now, let us examine the quintiles. How much income do you believe that a household would need to make the top 20%? The top 5%? The answer is given is the data on the following pages. In 2002, there were 111,278,000 households in the United States (with an average of about 2.6 people per household). If your household had an income of \$84,016, then 80% of American households earned less than you did while 20% of American households earned more. If your

## Share of Aggregate Income

	Lowest Fifth	Second Fifth	Third Fifth	Fourth Fifth	Highest Fifth	Top 5 Percent
2002	3.5	8.8	14.8	23.3	49.7	21.7
2001	3.5	8.7	14.6	23.0	50.1	22.4
2000	3.6	8.9	14.8	23.0	49.8	22.1
1999	3.6	8.9	14.9	23.2	49.4	21.5
1998	3.6	9.0	15.0	23.2	49.2	21.4
1997	3.6	8.9	15.0	23.2	49.4	21.7
1996	3.7	9.0	15.1	23.3	49.0	21.4
1995	3.7	9.1	15.2	23.3	48.7	21.0
1994	3.6	8.9	15.0	23.4	49.1	21.2
1993	3.6	9.0	15.1	23.5	48.9	21.0
1992	3.8	9.4	15.8	24.2	46.9	18.6
1991	3.8	9.6	15.9	24.2	46.5	18.1
1990	3.9	9.6	15.9	24.0	46.6	18.6
1989	3.8	9.5	15.8	24.0	46.8	18.9
1988	3.8	9.6	16.0	24.3	46.3	18.3
1987	3.8	9.6	16.1	24.3	46.2	18.2
1986	3.9	9.7	16.2	24.5	45.7	17.5
1985	4.0	9.7	16.3	24.6	45.3	17.0
1984	4.1	9.9	16.4	24.7	44.9	16.5
1983	4.1	10.0	16.5	24.7	44.7	16.4
1982	4.1	10.1	16.6	24.7	44.5	16.2
1981	4.2	10.2	16.8	25.0	43.8	15.6
1980	4.3	10.3	16.9	24.9	43.7	15.8
1979	4.2	10.3	16.9	24.7	44.0	16.4
1978	4.3	10.3	16.9	24.8	43.7	16.2
1977	4.4	10.3	17.0	24.8	43.6	16.1
1976	4.4	10.4	17.1	24.8	43.3	16.0
1975	4.4	10.5	17.1	24.8	43.2	15.9
1974	4.4	10.6	17.1	24.7	43.1	15.9
1973	4.2	10.5	17.1	24.6	43.6	16.6
1972	4.1	10.5	17.1	24.5	43.9	17.0
1971	4.1	10.6	17.3	24.5	43.5	16.7
1970	4.1	10.8	17.4	24.5	43.3	16.6
1969	4.1	10.9	17.5	24.5	43.0	16.6
1968	4.2	11.1	17.5	24.4	42.8	16.6
1967	4.0	10.8	17.3	24.2	43.8	17.5

household had an income of \$150,002, then only 5% of Americans earned more than you did. The top 5% of American households ranged from an income of \$150,002 to an income well over \$100,000,000. (In California the figures are higher.) If we define “rich” as having an income over \$150,000, then only about 5% of Americans are rich. **The point of this is that the number of “rich” people is very small in the United States; however, those that are rich are much richer than the rest of the society.**

As with most statistics, there is controversy concerning these statistics. For example, **what exactly is income?** These statistics include all earnings in the labor market plus cash transfers, such as social security or welfare benefits. They do not consider the taxes people paid on their incomes. Nor do they consider in-kind transfers, such as Food Stamps or Medicaid. Also, **how should we consider households of different sizes?** A household of two adults with an income of \$30,000 per year is in a very different situation from another with the same income but with eight children. The Census Bureau has tried to calculate the income distribution in many different ways. What they find is the following. **First, if one examine only earnings in the labor market, the distribution of income is more unequal than the distribution described above.** This means that cash transfers tend to make the distribution more equal than it otherwise would be. **Second, if all of the taxes paid are taken into consideration, the distribution is affected very little.** **Third, if in-kind transfers, such as food stamps and Medicaid, are taken into consideration, the distribution becomes more equal. But if other government programs, such as spending for education, are considered the reverse is true.** However, the conclusions discussed below do not seem to depend on the particular measure of income used.

**One of these conclusions involves a comparison of the distribution of income in the United States over time.** Have we been becoming more equal or unequal? In fact, **inequality decreased slowly until the middle of the 1970s.** The share of the top 20% (or top 5%) is reduced and the share of the bottom 20% increased. **Since the middle 1970s, inequality has increased considerably.** Inequality jumped in the 1980s. Then it took another jump in the middle 1990s. As one measure of this, a household at the 95<sup>th</sup> percentile had an income 8.2 times that of a household at the 20<sup>th</sup> percentile in 2002 compared to 6.3 times in 1967. **Yet, in the late 1990s, inequality may have reversed somewhat.** For example, among full-time male workers, the ratio of black income to white income rose from 0.71 in 1996 to 0.76 in 1999. As we will see, the rising inequality in household income is largely due to the rising inequality in earnings (leaving out the cash transfers). We will try to explain this phenomenon below.

**Another conclusion involves a comparison of the income distribution of the United States with that of other countries.** Are we more equal or unequal than other countries? **The United States has a more unequal distribution than do the other countries with whom the United States normally compares itself.** Germany and France are similar to the United States. Countries such as Canada, Britain, Belgium, Australia, and the Netherlands are more equal. The Scandinavian countries (Denmark, Norway, and Sweden) are even more equal. The most equal distributions are found in East Asian countries, especially Japan and Taiwan. On the other hand, the United States has a more equal distribution than Mexico or the Latin American countries. The fact that there is greater income inequality in other countries that are basically capitalist and market-oriented tells us that some aspects of income inequality are unique to the United States.

**Yet another conclusion involves the distribution of wealth.** Wealth represents the value of everything one owns (assets minus debts). When we say one is “rich”, we really are referring to wealth rather than income. Unlike income, there have been only a few surveys of the distribution of wealth. In recent years, the Survey of Consumer Finances has provided data for 1983, 1989, and 1992. From these, **we see that wealth is much more unequally distributed than income in the United States.** In 2000, the top **1%** of all wealth holders held **38%** of all of the wealth owned. The wealthiest 20% of owned over **80%** of all of the wealth owned in the United States. **Second, we see that wealth has also become more unequally distributed.** The share of the top 1% of households grew from 30% in 1983 to 38% in 2000. In 1992, an average household in the top 1% was 875 times wealthier than one in the bottom 40%. **Third, we see that financial wealth (stocks, bonds, and so forth) is even more unequally distributed than overall wealth.** In 1989, the top 1% of families owned 48%, and the top 20% of families owned 94%, of all of the financial wealth owned in the United States. This means that the bottom 80% of families owned only 6% of all of the financial wealth. **Finally, we find that wealth in the United States is more unequally distributed than in other countries.** For example, the top 1% of wealth holders held 18% of all wealth in Great Britain and 21% of all wealth in Sweden in 1990.

Our data on income inequality take a “snapshot” every year. While the bottom 20% of households earn a lower percent than they did previously, **we need to note that the people who comprise the bottom 20% (or any other percentile) are not the same from year to year.** Some people in the bottom 20% will move to higher levels in the future. And some people in the bottom 20% had been in higher percentiles in previous years. There have been studies that compare household incomes over varying periods of time. **These studies find considerable mobility.** For example, one study found that about 30% of households move between quintiles from one year to the next. Almost half will change quintiles over five years and almost two-thirds will change quintiles over a ten-year period. There is about equal probability that a household will move down to a lower quintile (usually due to loss of employment or to divorce) as will move up to a higher quintile (usually due to new employment, marriage, or a spouse becoming employed for the first time). Many in the lowest quintile are young people who will move up as they gain more work experience. **On the other hand, recent studies have found evidence of lower rates of intergenerational mobility.** Even though people do tend to find themselves in a higher or lower quintile than their parents were, there is a high correlation between one’s income and that of one’s parents. As just one example, a study from 1992 found that, if your father was in the bottom 20% of the income distribution, there was a 42% chance that you also would be in the bottom 20% of the income distribution. These data contradict one of the most deeply held values in the United States.

### Test Your Understanding

If a household had an annual income of each of the following, would you consider the household “rich”?

\$1,000,000	_____	\$100,000	_____
\$ 500,000	_____	\$ 75,000	_____
\$ 250,000	_____	\$ 50,000	_____
\$ 125,000	_____		

Using your answer to this question, what percent of American households would your group consider “rich”? \_\_\_\_\_

## 2. Why Has Income Become More Unequal Since 1980?

There has been concern about the increasing inequality in the United States over the past 25 years. Because of this concern, there have been many attempts to explain it. Some people have blamed the policies of the government during the administrations of Presidents Reagan and Bush (both Bush presidencies). **The claim here was that spending on government programs that aid the poor were reduced.** One of these programs, welfare, will be discussed later in this chapter. Another claim against the Reagan and George W. Bush administration involved reductions in taxes. **It was argued that the taxes were reduced mainly for the richer people with little tax reduction to the middle and lower income groups. But generally, the research shows that the changes in government programs and in the tax laws were NOT responsible for the increase in inequality. As noted above, most of the rise in inequality of incomes has been due to the increase in inequality of earnings from work, especially for men.** So let us consider some other explanations for this. As we do, keep in mind that most of the increase in inequality has yet to be explained.

People trying to explain the increase in inequality of earnings from work have considered supply-side factors, demand-side factors, and institutional factors. **Supply-side factors are those that would cause the supply of less-skilled workers to rise faster than the supply of higher-skilled workers.** One supply-side factor might be the increasing number of less skilled immigrants in the labor market. For the nation as a whole, immigration has had a small effect in increasing inequality. But for California, the effect is much larger. **One recent study concluded that immigration explains 30% to 40% of the increase in inequality of earnings among men in California.** This means that, in California, inequality increased 30% to 40% less for natives than it did for the population as a whole. Immigration also seems to be mainly responsible for the fact that California now has greater inequality than the rest of the nation. Immigration has had a much larger effect on the widening inequality in California because immigrants comprise so much greater a proportion of the California labor force (36% in 1997) than they do for the nation as a whole (12% in 1997). 67% of immigrants living in California were in the lower half of the income distribution. Other supply-side factors would include the increased labor force participation rates of married women, who tended to have less work experience, or the increased labor force participation rates of teens. However, since most of the rise in income inequality was due to a rise in inequality of labor market earnings among men, these changes had little effect in increasing income inequality.

**Demand-side factors are those that cause the demand for higher-skilled workers to increase more than the demand for less-skilled workers. An example of a demand-side factor would be changes in technology** that have increased the demand for more educated, more experienced workers, who are trained to use the new technologies, and decreased the demand for less-educated, less experienced workers, who may be replaced by the new technologies. **The expansion of international trade has been another demand-side factor** because trade increased the demand for higher-skilled workers who produce the goods America exports (such as computers or financial services) and decreased the demand for less-skilled workers who produce the goods America imports (such as textiles). Earlier, it was noted that the income gains from a college degree have increased substantially. Since 1980, the number of people attending and graduating from college has risen significantly. This increase in supply

should have caused the rewards from a college education to diminish. However, the median college graduate, who earned about 30% more than the median high school graduate in 1980, earned about 70% more in 1997. The income gains from experience have also increased substantially. The wage difference between those with 25 years of work experience and those with 5 years of work experience is much greater now than it was 30 years ago. (In California, natives with 25 years of experience earned 91% more than those with 5 years of experience in 1997, compared to 68% more in 1969.) **These facts illustrate that the increase in the demand for college graduates and for workers with considerable work experience has been much greater than the increase in the supply.**

**Institutional factors include the declining importance of unions and the decline in the inflation-adjusted value of the minimum wage.** These will not be discussed here.

**Research seems to show that demand-side factors have been much more important than supply-side factors in explaining the increase in earnings inequality.** Most people who have studied the question of increasing inequality conclude that the main factor has been the changes in technology. The expansion of international trade has had a small impact on increasing earnings inequality (as companies with little involvement with international trade have also reduced their demand for less-skilled workers). The decline of unions also seems to have had a small impact as did the decline in the purchasing power of the minimum wage. For the nation as a whole (but not for California), the supply-side factors seem to have played an even smaller role in increasing earnings inequality. However, it must be stressed that there is still much about the increase in inequality that is not understood.

### 3. Is Equality Desirable?

If the distribution of income or wealth were very equal, no one would object. But as we have seen, these distributions are nowhere near equal in the United States and are becoming more unequal. The question then becomes “is this inequality a bad thing?”. Should the government undertake policies to generate greater equality than the market generated?

**There are several arguments that have been made that equality is a good thing and should be promoted.** People who make these arguments do not mean that everyone should have exactly the same income or wealth. But they do mean that the distributions of income and wealth should be more equal than they presently are. **One argument for equality that has been made derives from the following argument.** Assume there are two people, A and B. A has an income of \$10,000 per year. B has an income of \$10,000,000 per year. Suppose that \$1,000 were taken away from B and given to A. What would B lose from not having \$1,000? Since B would still have \$9,999,000 with which to buy goods and services, the answer must be “not much”. After one has spent \$9,999,000 on goods and services, how much satisfaction can one gain from spending yet another \$1,000? What would A gain from getting the additional \$1,000? Since A has very little, the extra \$1,000 might mean that A would have better food or a place to live. The gain to A would seem to exceed the loss to B, making a net gain for society as a whole. (Most economists have shied away from this type of reasoning because they believe that accurately comparing satisfaction between people is not possible.) **A second argument for equality was made by a philosopher, John Rawls.** In his argument, imagine that you are waiting to be born. You are allowed to create whatever distribution of income you desire for the

world you will be born into. However, you do not know what your own position in the distribution will be. You could create a distribution that would have some very rich people and some very poor people. But you don't know whether you will be very rich or very poor. He argued that if people are risk-averse, they are most likely to choose a distribution that is relatively equal. This minimizes the worst outcome that could happen. Since people would choose relative equality, he argued, this is the most desirable distribution. **A third argument for equality involves equality of opportunity.** That people should have equal opportunity to pursue happiness is a strongly held American value. Yet, children of families with very high incomes or large amounts of wealth have much greater opportunity than others. They can go to the "best" universities. They have family funds to use to start businesses. It should be no surprise that many (but certainly not all) of the most successful entrepreneurs in the United States today, such as Bill Gates and Paul Allen of Microsoft, came from relatively affluent families. Earlier, it was noted that there seems to be only a low rate on intergenerational mobility in the United States. **A fourth argument for equality involves citizenship.** It is hard to have a democracy work when some people are able to give large amounts of money to politicians while others are not. It is hard to be "one nation" when the rich live in gated communities in suburbs while the poor live in slums in the inner city. Societies that are more equal tend to have less crime and less violence. And societies that are more equal tend to have less adversarial work relations between workers and management. Japan and Scandinavia, where the distributions are relatively equal, tend to have much more harmonious work relationships than are found in the United States or in class-conscious Britain. (A Japanese Chief Executive Officer earns 16 times the amount that the average Japanese worker earns. An American Chief Executive Officer earns 150 times the amount that the average American worker earns.)

**A final argument surrounding equality involves incentives.** The argument used to be made that inequality is needed to generate incentives to succeed. The thought of some day being rich would lead one to work hard, to save, and to become entrepreneurial. But the very good economic performance of the countries of Asia, which have very equal distributions of income, called this view into question. In Asia, relative equality, hard work, saving, and entrepreneurial behavior have all gone together. However, the distributions of income and wealth are relatively equal in Asia for historical reasons, not due to the actions of the Asian governments. In the countries of Europe and in the United States, the distributions were quite unequal but the government acted to increase equality by taking from the richer people (through high taxes) and giving to the poorer people (through transfers and spending programs). In this case, **the act of equalizing may have created negative incentives.** In particular, the higher taxes on the non-poor and the transfers to the poor may have discouraged work and savings. **The analogy has been made to a leaky bucket.** (Water is taken from areas that have much water and brought to areas with little. But some of the water spills along the way.) The effect on incentives of the possibility of becoming rich is considered in the next section. The effect on incentives of transfers and spending programs is considered later.

#### 4. The Super-Rich

Earlier it was documented that the "rich", measured either by income or by wealth, are a small group of people. However, they can be very very rich. In 1996, there were 132 billionaires in America. One billion dollars was equal to the income of about 25,000 average workers in a year. If we define billionaire in this way for comparison (having 25,000 times the

income of the average worker), there were only 23 such people in 1982 and only 13 in 1968. How did they come to be this way? For many, the answer is that they inherited considerable wealth. But this only pushes the question back to a previous generation. Where did the great wealth originally come from? The answer in most cases is surprisingly similar. **Great wealth began with economic profits from the realization of some degree of monopoly power over a product that was in demand.** Eventually, market forces eliminated this monopoly power as new sellers provided the same or similar products, increasing supply and lowering prices until the economic profits disappeared. **The people possessing the monopoly power resisted the elimination of their power.** Sometimes they were able to maintain their power for a considerable time. Sometimes the power eroded rather rapidly. **But, while the monopoly power lasted, these people were able to accumulate a considerable fortune.** Once the power was eliminated, they were able to maintain the fortune by investing it into many different types of investments (stocks, bonds, and so on). It is rare to see an individual accumulate a fortune on more than one venture in a lifetime.

The story of many of the great fortunes fits this scenario. Bill Gates' fortune came from purchasing the rights to DOS, having DOS installed on the IBM personal computers, and then having DOS become the industry standard. The Rockefeller fortune was accumulated by developing a virtual monopoly of oil and, by some controversial means, maintaining this monopoly for over thirty years. The Duke fortune (Duke University) was accumulated by achieving a monopoly in tobacco (American Tobacco). In both the Rockefeller and the Duke cases, the monopoly power was ended by government anti-trust actions. Several of the great fortunes were accumulated by gaining monopoly power over railroads. In the east, the fortunes of Harriman and Vanderbilt and in the west, the fortunes of Stanford and Huntington came from this monopoly power (see below). The power of the railroad monopolies ended as more railroads came into various markets and as trucks and airlines came into existence. The great fortune of Carnegie came from domination of the steel industry. The great fortunes of the Hunts and the Gettys came from artificially high prices of oil in the 1950s and the 1960s. These artificially high prices were the result of a cartel – one that was operated by a government agency called the Texas Railroad Commission. In San Diego, the fortune of Sol Price came from the development of a new type of shopping --- low prices available to people who buy in very large quantities in stores that are huge and that carry large numbers of different products. This began with Fed-Mart in the 1960s and was later followed by the Price Club (now Costco). Neither “monopoly” lasted long, as they were copied by others, but both provided a large amount of economic profit. On a national level, the fortune of Sam Walton was made in a similar manner. His Wal-Mart stores were always located just outside of small rural towns where they could gain market power over the much smaller stores that existed in the towns. The large fortune of Irwin Jacobs came from achieving a dominant position in telecommunications, particularly in wireless communications. His company, Qualcomm, gained a leading position in its industry.

Let us say that you start or buy a company that is earning economic profits. Because of its monopoly position, and because the product is in demand, you can earn a 20% return on ownership of your company. You put \$1,000,000 into buying the company and the profits each year are \$200,000 (20%). Let us say that the only alternative for the money is a savings account paying an interest rate of 5%. You can keep collecting your \$200,000 each year. But this would not make you rich. To become rich, you need to sell your shares to the public (perhaps keeping some shares for yourself in order to be able to control the company). How much can you get for your shares? The answer is \$4,000,000. This is so because, if they pay you \$4,000,000, buyers

will earn 5% on their money (\$200,000 divided by \$4,000,000), which is the same as they could earn on the alternative savings account. You have quadrupled your money. All of the fortunes mentioned above, as well as most of the computer fortunes of the 1980s and 1990s, were gained in this way. Because of the need to sell shares, the company must use the services of a specialist in selling shares – called **an investment banker**. Providing these services is the source of the fortunes of J.P. Morgan in the early 20<sup>th</sup> century and of Michael Milken in the 1980s. The close connection between the companies and their investment bankers allowed people to raise large sums of money and direct them to activities that would make themselves rich.

When one looks at the source of the great fortunes, one also commonly finds ruthless behaviors. Sometimes one also finds corruption. For example, in the mid 1860s, Leland Stanford, Colis Huntington, Charles Crocker, and Mark Hopkins put some of their money into the creation of the Central Pacific Railroad – the western part of the first transcontinental railroad. They used this, plus a subsidy they got from the federal government, to sell stocks and bonds worth \$79 million. The \$79 million was then expended to a company called the Central Pacific Credit and Finance Corporation. This company spent about \$50 million in wages and for materials to build the railroad. The other nearly \$30 million was given to its shareholders. Who were these shareholders? Stanford, Huntington, Crocker, and Hopkins. Who at the Central Pacific Railroad approved this? Stanford, Huntington, Crocker, and Hopkins. What happened to the other stockholders of the Central Pacific Railroad? They owned a railroad that was worthless. Today, there is Stanford University, Huntington Beach, Huntington Park, the Huntington Library, and the Mark Hopkins Hotel.

Large fortunes have been very controversial. Those who oppose them see them as illegitimate since they are derived from monopoly power or believe that they are divisive to society, as explained in the last section. Those who support them see the economic profits as lasting for a relatively short time and as providing incentives to provide new products that people like (personal computers or wireless communication) or to produce in ways that are more efficient (Price Club or Wal-Mart). The question then is: are the behaviors of those who gain large fortunes on the whole good or bad for society? One interesting answer was put forth a few years ago. The authors started by assuming that there are indeed a few very talented people. These people are paid great sums because, most of the time, they generate great value. So, for example, Michael Eisner, who earned \$50 million in one year as the Chief Executive Officer (CEO) of Disney, improved Disney from a poorly performing company to the best performing company in the entertainment industry. And certainly the computer billionaires have added great value. In the past, it was common for companies to promote from within. Most of the top executives worked their entire careers in the same company. Now it is common for the best talent to move from company to company. Just like free agency in sports, this has allowed the most talented people to receive their market pay --- to be paid according to the value they create. Since much of the difference between success and failure of the company depends on the talents of very few people, these people are greatly in demand and command very high incomes. (For example, thousands of people work on a movie but the success of the movie depends mainly on the director, the writer, and the two or three main actors or actresses. And much of the success of the Chicago Bulls depended on one player.) The authors call these **“winner take all” markets**. Yet, according to the authors, these kinds of situations generate a market failure. The fact that the “winner” will reap an enormous income generates intense competition to decide who the

“winner” will be. As a result, too many people enter the competition. So we see too many aspiring basketball players, too many aspiring rock musicians, too many aspiring lawyers, too many aspiring dentists, too many MBAs, and so forth. Society loses the value of what these people could have produced had they done something else. Since these people might have been better suited for engineering, teaching, civil service, etc., the value that society loses is much greater than the value it gains. This is the market failure.

### Test Your Understanding

In magazines, books, or on the Internet, find the story of a billionaire who is not mentioned in the text. You may use one who is currently alive or an historical person. Write a brief description of the source of this person’s great wealth. (If the wealth was inherited, go back to discover the original source of the wealth.) To what extent is your description of the source of this person’s great wealth consistent with the description in the text?

## 5. Poverty

Just as we can examine the very rich, we can also examine the very poor. In the early 1960s, the President of the United States declared a “War on Poverty”. The first necessity to “fight this war” was to find out just how many people were poor and who they were. At the time, there was no official definition of poverty. A staff economist at the Social Security Administration developed such a definition by beginning with the cost of a minimally adequate diet. Such a minimally adequate diet had been developed by the U.S. Department of Agriculture in 1961. She then multiplied the cost of this minimum adequate diet by three, believing that people at the time spent one-third of their income on food. This calculation, estimated at around \$3,100 for a family of two adults and two children in 1963, is called the **poverty threshold**. Since that time, the threshold is adjusted every year to reflect price inflation. In 2003, the poverty threshold was \$18,810 for a family of two adults and two children. \$18,810 in 2003 represented approximately the same purchasing power as \$3,100 did in 1963. The poverty thresholds are different for different family sizes. So, in 2002, the thresholds were \$9,183 for a single person and \$30,907 for a family of eight. They are also different in different areas of the country, being higher in California to reflect the higher cost of living. (The poverty threshold in San Diego for a family of four in 2003 was \$25,180.)

### Does this official definition of poverty really tell us the extent of the problem of poverty?

As important policy decisions are based on the official definition of poverty, you can imagine that the definition has been criticized by many people. **One criticism is that people do not spend one-third of their incomes on food.** Most Americans spend closer to 1/7 of their incomes on food. If we multiplied by 7, instead of 3, the number of poor people would be very much higher. **A second criticism comes from people who believe that poverty is a relative concept, not an absolute one.** This means that there should be no fixed standard to decide who is poor. Poverty must be determined in relation to the standards of living of the rest of society. People we consider poor have a standard of living many times greater than rich people did 200 years ago. But they are still poor if they have a standard of living well below the rest of today’s population. (For example, if most people have indoor plumbing, then you have a problem if you do not. It does not help you to know that people did not have indoor plumbing 200 years ago.) In the early 1960s, the poverty threshold for a family of two adults and two children was between 50% and 60% of the median income. In 2002, this same poverty threshold was just 36% of the

median income. People who believe that poverty is a relative concept suggest that the poverty threshold be set at some percent (say 50%) of the median income. Obviously, the number of poor people would have been much greater with this definition. (Using today's absolute measure of the poverty threshold, and adjusting for inflation, we would say that about 70% of Americans lived in poverty in 1900. Such an idea makes no sense.) **A third criticism involves the manner by which income is measured.** In the poverty calculations, income includes income from work plus cash transfers from the government (such as social security or welfare). It is argued that non-cash transfers (such as Food Stamps or Medicaid) should also be included and that taxes paid should be subtracted. If this is done, the poverty rates are lower since the poor receive more in non-cash transfers than they pay in taxes. **A fourth criticism involves the inflation rate that is used to adjust the thresholds.** For reasons we shall not consider here, the inflation rate probably overstates the true rise in the cost of living. If the inflation rate measure were more accurate, the thresholds should be lower, reducing the number of people categorized as poor. These and other issues are presently being considered by the Census Bureau in determining whether the official definition of poverty ought to be re-defined. Finally, the definition is absolute: one is either poor or not poor. The definition does not tell us how close to the poverty line people actually are. So, giving every poor family \$1,000 would reduce the poverty rate by about one percentage point. 4.5% of Americans were within 125% of the poverty threshold, showing that many of those who are not officially poor live very close to the poverty threshold

**How many people are poor?** In 2003, nearly 36 million people, 12.5% of all Americans, were considered officially poor. In 2003, 13.4% of all Californians and 14.5% of all San Diegans were officially poor (348,500 San Diegans). **Poverty rates fell considerably from the late 1950s until the early 1970s.** This result was widely hailed. The country was "winning the War on Poverty". **But after that, the poverty rates leveled off before rising in the 1980s and 1990s.** From 1995 to 2000, poverty rates fell once again. However, the poverty rates are still higher than they were from 1968 to 1980. This is a very disappointing result. The economic growth of the 1990s did lift many people out of poverty. But there are many others not helped by a growth of production and income in the nation. Full employment seems necessary, but not sufficient, to cure poverty. Poverty rates have risen since 2001 as the economy has worsened.

**Who are the people who are poor?** We can categorize them in many ways. Using the 2003 data, we find that of the nearly 36 million people officially categorized as poor, about 45% were white, 25.7% were black, 24.7% were Hispanic, and 4% were Asian and Pacific Islander. Therefore, **while most of the poor are white, minority groups are over-represented among the poor.** And 14.7% of the poor are immigrants (and almost 20% of all immigrants are officially poor). **What seems especially disturbing is that poverty is largely a phenomenon of young people.** Just about 40% of all of the poor people are under the age of 18 (and 16.7% of all people under age 18 are officially poor). **Poverty also is connected to the breakdown of the traditional family.** Among people who live in married couples, with both husband and wife together, the poverty rate was 6.4%. But among those who live in female-headed families, the poverty rate in 2002 was 26.5%. Nearly half of the poor lived in families with a female head, no husband present. **Many of those who are officially classified as poor do indeed work.** Of those classified as poor, 6.6% worked full-time for the full year and 20% worked part-time for the whole year. Another 16% worked for part of the year. Therefore, only 42% of the poor age 16 and over worked at all. Of those who did not work, 24% were disabled, 27% were retired, and

23% cited family responsibilities. This is the reason that economic growth has such a limited impact on the poverty rate. **Finally, there has been a large reduction in poverty among the elderly.** Only 10.4% of people age 65 and over were classified as poor in 2002. Forty years ago, the elderly comprised perhaps 40% of the poor. This reduction is often considered the greatest achievement of the War on Poverty. Poverty, which was once borne heavily by the elderly, is now borne heavily by young people.

While the data show the poverty rate for each year, it must be remembered that the same people are not poor every year. Some of the people who are poor in 2004 were not poor in 2003. And some of the people who are poor in 2004 will not be poor in 2005. We need to examine the dynamics of poverty to assess how great the problem is. A major study of this was done using the data from 1968 to 1987. **It found that most people who experience poverty do so for only a short time.** Indeed, of people in poverty at any particular time, nearly 60% would be poor for less than one year. While they would rise out of poverty, many would have their incomes rise to only a bit above the poverty threshold. They were much less likely to rise into the middle class. The most common reasons for falling into poverty were loss of a job or divorce. The most common reasons for rising out of poverty were finding a new job or re-marriage. But while most people who experienced poverty did so for only a short time, **the data also showed that there was a sizable group, perhaps 20% of the poor, who would be poor for a long time** (at least seven consecutive years). For these people, the problem of poverty is a severe and persistent one.

## 6. Government Programs to Aid the Poor

The government has long had programs designed to aid the poor. Some of these are “**means-tested**” while others are not. (*“Means-tested” means that one must have a low income to be able to receive the benefits of the government program.*) Of the amount spent by the government on “welfare state” programs, about 2/3 was not means tested. Most of this amount was spent on Social Security and Medicare. **Social Security** provides income for retirees, income for survivors if a spouse or parent dies, and income for those who are disabled. **Medicare** provides medical care for people age 65 and up who qualify for social security. About 9% of all “welfare state” goes to cash transfers to the poor --- mainly **AFDC** (see below) and **Supplemental Security Income (SSI)** for the elderly poor and the disabled. The rest goes to in-kind transfers to the poor— mainly **Food Stamps, Housing Assistance, and Medicaid.**

Of all of the “welfare state” programs, the one that received by far the most attention was **Aid to Families with Dependent Children (AFDC)**. Indeed, people usually said the word “welfare” when referring to AFDC. Prior to 1996, in a typical month, between 4 ½ million and 5 million families were receiving this cash assistance. In all states, the AFDC program provided income for female-headed families – a mother and at least one child. In some states, including California, aid was also provided for two-parent families if the main earner in the family became unemployed. As of 1998, a mother with two children and no other income received about \$565 per month in California. This benefit would decline for every dollar of income earned by working. A household eligible for AFDC would also receive Food Stamps (which averaged \$189 per household in 1997) and Medicaid. Some would also be eligible for rent supplements (in this program, the household pays 30% of its income for rent and the government pays the

rest, up to a limit on the total rent).

In 1997, there were about 2,225,000 people receiving AFDC payments in California. The large majority of these people collected AFDC for only a short period of time. For these people, AFDC was a transitional program. It got them through especially rough periods in their lives, commonly brought on by divorce, by job loss, or by the need for a single woman to adjust to the birth of a new child. But while most people collected payments for only a short time, most of the total spending on the AFDC program went to that minority of people who collected benefits for a long time period. Perhaps  $\frac{1}{4}$  of those who collected benefits did so for at least ten years. These people are often called **“welfare dependent”**. Research showed that the critical time was two years. Most recipients collected benefits for less than two years. But those who collected benefits for more than two years were the ones likely to continue collecting it for a long time period.

AFDC was the target of frequent criticism. When the program was created in the 1930s, most of the recipients were widows with children. These people were expected to devote their time to raising their children and not to work. But values have changed now. The public now believes that women collecting welfare benefits should learn to work to support themselves. The AFDC system did little to encourage the women to work. Indeed, unless a woman could command a fairly decent wage and unless childcare costs were reasonably low, she was often no better off by working than by collecting the AFDC benefits. One study concluded that the AFDC program decreased work hours of the recipients by 30%. Various other studies have concluded that taxpayers must pay between \$1.29 and \$1.89 (depending on the study) to raise the incomes of recipients by \$1.00. (This result occurs because recipients choose to earn less when the benefits are available.) Return to the metaphor of the leaky bucket. Apparently 20% to perhaps nearly 50% of the money “leaked out” as income is transferred to the poor.

AFDC was also criticized for other incentive effects. **First the public also believes that the fathers of their children should financially support their children.** But the welfare system did a very poor job at collecting child support from the absent parent. **Second, the benefits paid to recipients necessitated an increase in taxes.** This increase in taxes may have had disincentive effects. By reducing the reward from working and saving, the higher taxes may have reduced work effort by the non-poor and also reduced savings. **Third, the presence of AFDC may have generated a greater number of female-headed families by allowing young single mothers to live separately from their own parents.** **Fourth, the existence of AFDC benefits may have encouraged more out-of-wedlock births.** These points have been extensively studied. Most studied found that these incentive effects were small. Nonetheless, they were major arguments as the case was made for reform of the welfare system.

The most recent, and most significant, reform of the welfare system occurred in 1996 with the **Personal Responsibility and Work Opportunity Act**. AFDC no longer exists; the program is now called **Temporary Assistance for Needy Families (TANF)**. Basically, a woman now is allowed to collect benefits for no more than two years consecutively. She is expected to use that two-year period to become ready for employment. At the end of the two-year period, she must become self-supporting. The woman is allowed to return to the welfare system if needed, but can collect benefits for no more than five years in a lifetime. (Several states have shortened this five-year maximum.) This reform guaranteed that full-time work, even at the minimum wage, would make a family better off than would welfare. But the reform did create an issue as to whether the labor market could absorb perhaps three million new workers. Since about 40% of

those collecting benefits had failed to finish high school and, on aptitude tests, 75% of recipients had scores that placed them in the bottom 25% of all test takers, it was feared that they would be hard for the labor market to absorb. Between 1993 and 1999, the number of Americans receiving cash aid fell 44%. Since these policies were enacted at a time of a booming labor market, the policies seem to have worked well. In June of 1999, 6.9 million people were receiving welfare, compared to 14.4 million in 1993. The proportion of Americans on welfare fell from 5.5% in 1993 to 2.5% in 1999. While the government spending for welfare declined, the government policies to aid the working poor rose greatly (due to the increase in the minimum wage, the Earned Income Tax Credit, and the coverage under Medicaid). In 1986, a single parent working full time at the minimum wage would earn only \$2,000 more in a year than being on welfare. And that parent would lose medical coverage by working. By 1997, the same single parent would increase earnings by \$7,100 per year by working full time at the minimum wage. And while the parent would lose medical coverage by working, her children would not. People seem to have responded to these incentives as it was hoped they would. In addition, the birth rate for teenage women fell sharply (from 62.1 births per 1000 women in 1991 to 51.1 in 1998) despite a drop in the abortion rate. In 2001, the American economy entered a recession and the unemployment rate rose. The economy has recovered slowly and the unemployment rate is still relatively high. It is possible that the new reforms could cause considerable suffering in a period of higher unemployment. This remains to be seen.

### Test Your Understanding

1. In 2003, the poverty threshold for a single person residing in San Diego was approximately \$1,100 per month. Form a budget for yourself, assuming that you have exactly this income. Consider all of your expenses. (If you are not single, the poverty thresholds are different: \$1,364 for 2 adults, \$1,404 for one adult and one child, \$1,640 for 2 adults and one child or for one adult and two children, \$2,066 for 2 adults and 2 children, etc. Use these numbers to prepare your budget.)
2. In 1997, the poverty rate for the United States was 13.3%. But the poverty rate for California was 16.8%. Based on what you know about the causes of poverty and the type of people likely to be poor, what hypotheses can you develop to explain why the poverty rate is higher in California?
3. Assume that you are a major policy maker in the United States. Your goal is to devise policies to greatly reduce the number of people in poverty in the United States. What policies would you recommend? Why? Keep in mind that most of the policies your group would recommend have been tried in the past. Explain why these policies have not worked as well as the people who proposed them had hoped. (That is, what difficulties are your policies likely to encounter?)
4. Go to the following site on the internet:  
<http://www.census.gov/hhes/income/incineq/p60tb3.html> There you will find the mean (average) income received by each 5<sup>th</sup> and by the top 5%. Choose the most recent year. How much additional tax (as a percent of their average income) on households with incomes in the top 5% would be needed to raise the average income of households in the lowest quintile by 10%. Remember that for every 5 households in the top 5% there are 20 in the lowest quintile.

## Practice Quiz on Class 19

1. Which of the following is true about **the distribution of income of the United States**?
  - a. It has been getting more unequal over time
  - b. It is more unequal than most other countries
  - c. It is more equal than the distribution of wealth
  - d. All of the above
  
2. Which of the following would be closest to the percent of total income earned by the richest 20% of households?
  - a. 20%
  - b. 25%
  - c. 50%
  - d. 100%
  
3. Which of the following could explain why income has become more unequally distributed over the past 20 years?
  - a. the demand for higher skilled workers has risen faster than the demand for lower skilled workers
  - b. the expansion of immigration
  - c. the decline of labor unions
  - d. all of the above
  
4. The **poverty threshold**:
  - a. was calculated as the cost of an adequate diet times three and then is adjusted for inflation
  - b. measures income by wages plus cash transfers, excluding taxes and in-kind transfers
  - c. has fallen as a percent of the median income
  - d. all of the above
  
5. According to the text, the source of great fortunes is
  - a. inheritance
  - b. monopoly power
  - c. education
  - d. luck
  
6. Which of the following number would be closest to the percent of Americans officially poor?
  - a. 0
  - b. 12%
  - c. 25%
  - d. 50%
  
7. Which of the following statements is/are true?
  - a. The percent of Americans in poverty has been falling steadily since 1970
  - b. Most poor people experience poverty for a long time period
  - c. AFDC was an example of a means-tested program
  - d. Raising the incomes of the poor by \$1.00 costs taxpayers less than that \$1.00
  - e. All of the above
  
8. The program that replaced AFDC is called
  - a. Social Security
  - b. Medicare
  - c. Food Stamps
  - d. Temporary Assistance for Needy Families

Answers: 1. D 2. C 3. D 4. D 5. B 6. B 7. C 8. D