Poverty and Income Distribution

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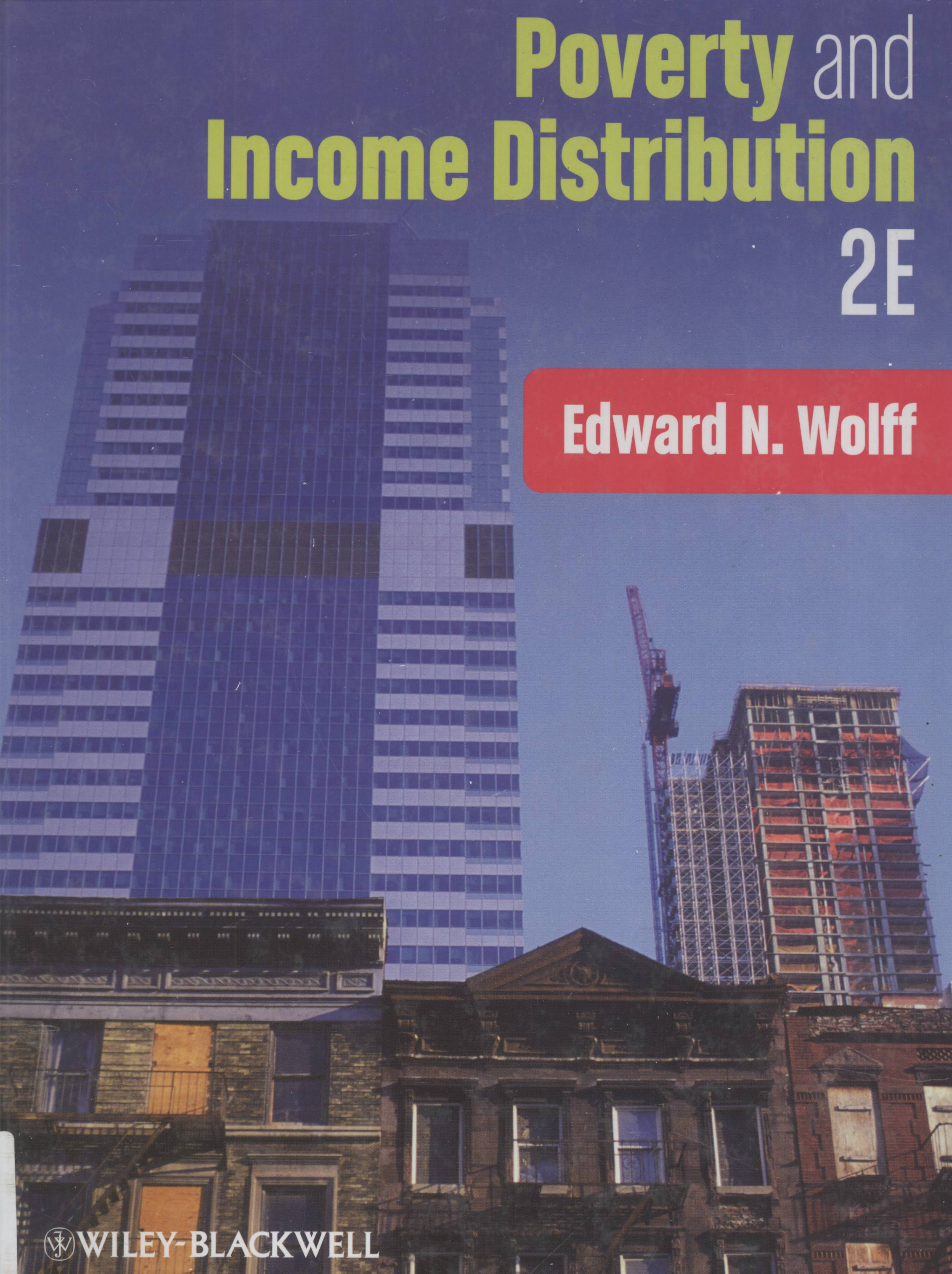
Edward N. Wolff



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EDWARD N. WOLFF

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Poverty and Income Distribution

Preface

This book developed as an outgrowth of my own course, "Poverty and Income Distribution," which I have taught at New York University on and off since 1977. The textbook incubated over many years. Because of a scarcity of textbooks in the field in the 1970s, I developed my own set of lecture notes, which I later distributed to students. Over time, with feedback from students (the course typically had 40 students per semester), the lecture notes eventually evolved into this textbook. In this way, the textbook was constantly subjected to student reaction. Sections whose exposition was unclear were refined and rewritten. Topics that did not seem of interest to students were dropped and new ones added. The data used in the book were periodically updated.

The book also changed focus over the years. In the late 1970s, there were only inklings of the dramatic changes that were to befall the U.S. economy. The original focus of the course was on the measurement of inequality and poverty and explanations of inequality. Since the only well-developed models of inequality at that time were for labor markets, the course also had a heavy dose of labor economics. Moreover, at that time, the most widely used and most fully articulated model was human capital theory, so that considerable space was also devoted to this topic.

However, by the late 1980s, when the writing of this book began in earnest, the three-fold malady of falling real wages, stagnating living standards, and widening income disparities had become apparent. In addition, poverty rates, which had leveled off in the 1970s, began rising again in the 1980s. The numbers themselves tell a dramatic story. As a result, the book began to emphasize the actual statistics themselves as a way of telling the story of these disturbing changes in the U.S. economy (and other economies as well).

Some economists who teach in this field may feel that the book has, perhaps, an overdose of statistical evidence. Moreover, it is admittedly much harder to examine students on statistics than on economic theory. However, my own feeling is that numeracy is crucial in its own right. It is important to give students a feel for the actual magnitudes involved. If nothing else, an awareness of these figures will help students become more knowledgeable citizens and help them better understand the statistics that are periodically reported in our major newspapers and magazines.

The book maintains a strong emphasis on the role of labor markets. There are two reasons for this. First, about three-quarters of personal income arises from labor activities. Second, many public policy programs, most notably social security, are linked either directly or indirectly to labor market activities. This may create some overlap between this text and traditional labor economics, but the stress here is different – much more on the relation between labor activity and inequality. In my treatment of the human capital model, for example, the stress is on the determination of earnings differences between individuals. The book also provides a wider coverage of models of the labor market than is found in more traditional labor economics courses. Institutional models are given particular attention – such as internal and dual labor market theory, inter-industry wage differentials and efficiency wage theory, and structural models – because of the recent stress on the demand side of the labor market as a source of earnings inequality.

A section of the book is devoted to the inequality of household wealth, which is my own research specialty. As it turns out, changes in inequality are much more dramatic in terms of household wealth than in terms of income. Indeed, it appears that changes in income inequality become magnified in terms of wealth disparities. There is again a heavy emphasis on the statistical evidence, though a chapter in this section treats the determinants of wealth differences between families. The major focus is on lifecycle theory, since it is still the primary model on this subject. However, there is also a lengthy discussion on the role of inheritances, because they also play an important role in explaining disparities in wealth holdings among households and also raise some crucial ethical issues.

Discrimination is also another persistent problem, which seems unlikely to disappear over the next several decades, and a whole section of the book concentrates on this issue. This issue has grown in leaps and bounds in Europe as it deals with the economic problems of its immigrants and the less than ideal intergenerational mobility of these immigrants' children and grandchildren. The news in the United States is particularly distressful for African American families, who after making some progress in closing the income gap relative to white families between the early 1960s and the mid-1970s now find their relative incomes at the same level as in the early 1960s. Poverty rates also remain much higher for blacks than for whites. The role of public policy, particularly affirmative action, in explaining the changing fortunes of minorities is given considerable emphasis. This subject is especially topical today in light of recent decisions by the Supreme Court and recent attempts by members of Congress to dismantle the system.

The last part of the book treats the role of public policy on both poverty and income inequality. This tends to be the section of the course that elicits the most student interest and participation. Because of the political discourse on this subject and the emotions it raises, I have found it particularly useful to "lay out the facts." The first chapter of this part examines the social security system and the welfare system in some detail. Most students are surprised by the fact that the resources devoted to the former are many times those spent on welfare. The second chapter describes the workings of the U.S. tax system. Here, too, there is considerable surprise that the overall tax burden has changed relatively little over time and that the tax system as a whole appears to favor neither the rich nor the poor and, as a whole, is distributionally neutral.

International comparisons also play an important role in this book. It becomes clear throughout the text that among the industrialized countries of the world the United States is really a special case both in terms of the level of inequality and the degree of increase of inequality since the 1980s. It also becomes apparent that U.S. poverty rates are exceptionally high when compared to countries at similar levels of development.

The book also extensively documents and discusses inequality and poverty trends in advanced countries (Canada, Europe, and East Asia) other than the United States and in less developed countries as well. We show that inequality is a problem in Europe as well and that the level of inequality is strikingly high in some European countries. Moreover, both income and wealth inequality have been increasing in other advanced countries. However, the "welfare states" in many European countries have considerably lowered both poverty and inequality relative to what it would have been without such extensive income transfers. Economic discrimination in Europe and various East Asian countries, particularly with regard to gender, is quite high (and worth examining in some detail). Some developing countries are catching up with the advanced countries both in terms of per capita income and according to a broader measure of average well-being called the Human Development Index. It also appears that the world distribution of income inequality follows the inverted U-shape of the so-called Kuznets curve.

The textbook serves as a self-contained course on income distribution and poverty, with additional emphasis on issues of discrimination. It is designed mainly for undergraduates who have had a full-year economics principles course but does not require any economics beyond this level. A statistics course is helpful but not necessary, since several sections on basic statistics are also included. There are some sections of the book which contain discussion of econometric studies and more advanced mathematical treatments of inequality measurement. However, these sections (which are starred) are optional and can be skipped without interfering with the continuity of the text.

The principal audience of the textbook is likely to be undergraduate economics students. However, the book can also be used as a core text in a masters level economics course on the same topic and as a primary or secondary text in a similar course in sociology, political science, or public administration (either undergraduate or masters level). Moreover, there are sections of the book that would be suitable for a Ph.D. level course in economics, sociology, political science, or public administration. The book can also serve as a supplementary textbook in courses in labor economics, discrimination, and public policy.

On the basis of my past experience, an instructor should be able to cover Chapters 1–6, 8, and 12–16, excluding the starred sections, in a full one-semester undergraduate course. The material in these chapters is almost completely self-contained. I have also included both discussion questions and numerical problem sets at the end of most chapters. I find that the problem sets are very helpful for the students in mastering the various measures developed in the textbook (such as the Gini coefficient).

Finally, this version of the textbook benefited greatly from the excellent and thorough comments supplied by reviewers. Since they have agreed to be identified, I would like to thank them for their help:

Charles L. Ballard, Michigan State University
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Lars Osberg, Dalhousie University
Wendy Rayack, Wesleyan University
Michael Sattinger, SUNY Albany
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Jennifer Warlick, Notre Dame

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Contents

* Section contains more advanced material or special topics that may be omitted without losing continuity in the book.

Chapter 1
Introduction: Issues and Scope of Book

1.1 RECENT TRENDS IN LIVING STANDARDS

In this section, the author presents his *own* views about the development of the U.S. economy over the last 50 years. Please note that other researchers may differ in their opinions about these recent developments in U.S. living standards. A number of new terms are also introduced here. These will be formally defined in the ensuing five chapters. However, this section may serve as a way of motivating readers to delve more deeply into the subject matter of this book.

1.1.1 Income and earnings stagnate while poverty remains unchanged

The early years of the twenty-first century have witnessed a struggling middle class despite robust growth in the overall U.S. economy. During the first part of the George W. Bush administration, from 2001 to 2005, the economy (GDP in real dollars) expanded by 14 percent despite a brief recession in 2001, and labor productivity (real GDP divided by full-time equivalent employees) grew at an annual pace of 2.2 percent. Both figures are close to their post-World War II highs for similar periods.

Despite the booming economy, the most common metric used to assess living standards, real median family income (the income of the average family, found in the middle of the distribution when families are ranked from lowest to highest in terms of income), actually *fell by 3 percent*.[1] From 1973 to 2005 its total percentage gain amounted to 6 percent. In contrast, between 1947 and 1973, median family income almost exactly doubled (see Figure 1.1).

Mean (or *average*) family income likewise doubled between 1947 and 1973 and then increased by 21 percent from 1973 to 2005. This is less than the increase over the preceding quarter-century but greater than the rise in median family income. The disparity between the two reflects rising inequality since the early 1970s (see below).

Another troubling problem is poverty. Between 1959 and 1973, there was great success in reducing poverty in the United States, with the overall poverty rate declining by more than half, from 22.4 to 11.1 percent (see Figure 1.2). After that, the poverty rate has stubbornly refused to go any lower. After 1973, it trended upward to 15.1 percent in 1993, then fell back to 11.3 percent in 2000, only slight above its low point, but then rose again to 12.6 percent in 2005.

Another indicator of the well-being of lower income families is the share of total income received by the bottom quintile group (20 percent) of families (see Figure 1.3). Their share rose from 5 percent in 1947 to 5.7 percent in 1974, its high point. Since then it fell off rather sharply to