

**Labor Markets,
Poverty, and
Income Distribution**

CHAPTER
13

Introduction

- Observations
 - People with similar skills earn very different incomes.
 - Some of the worlds wealthiest people come from poor countries.
 - Many Americans are homeless and malnourished.

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The Economic Value of Work

- The Market for Labor
 - Equilibrium wage and quantity are determined by the supply of and demand for a specific category of labor.
 - Changes in supply and demand will change the equilibrium wage and quantity.

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The Economic Value of Work

- Observation
 - Wages will differ among workers with different levels of productive ability.
- The wage equals the value of marginal product (*VMP*).

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The Economic Value of Work

- How much will Rennie and Laura earn at Mackintosh Pottery?
 - Price = \$1.10/pot in competitive market
 - Clay, the only input, available at no cost .
 - Cost = \$0.10 handling fee/pot.
 - Rennie produces 100 pots/wk and Laura produces 120 pots/wk.

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The Economic Value of Work

- Value of Marginal Product
 - Marginal product of labor x the net price of each unit sold
 - ◆ Rennie's *VMP* = (100 pots)(\$1.10 - .10) = \$100
 - ◆ Laura's *VMP* = (120 pots)(\$1.10 - .10) = \$120
- Assuming a competitive labor market:
 - Rennie's wage will be \$100.
 - Laura's wage will be \$120.

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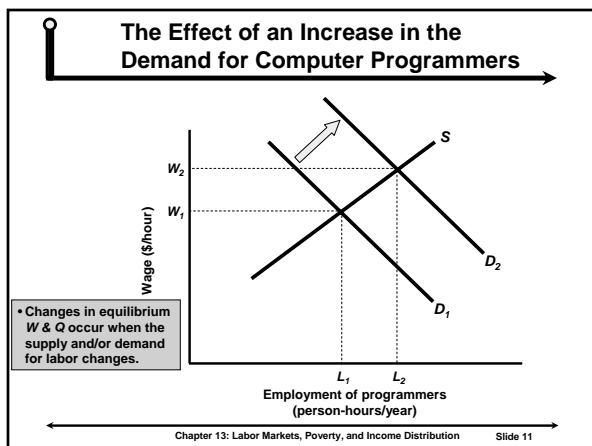
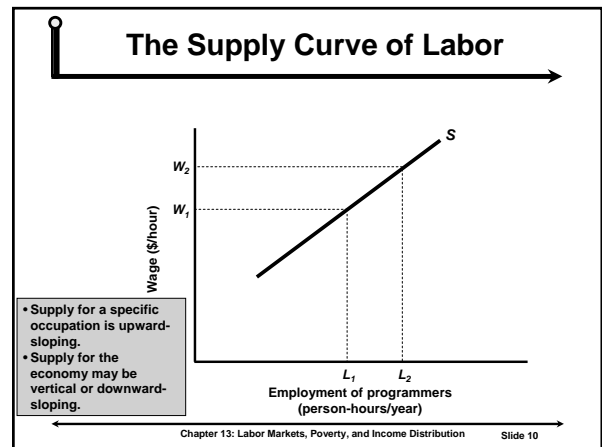
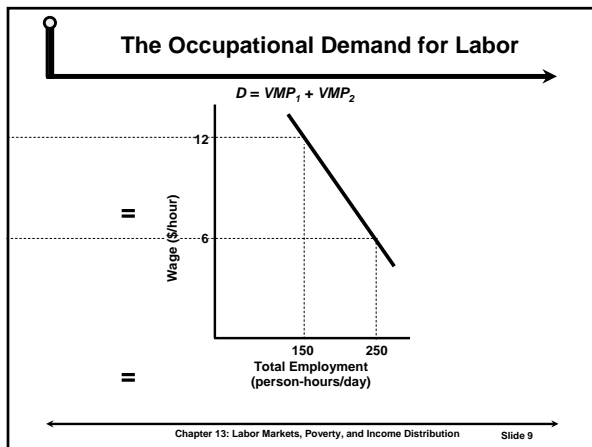
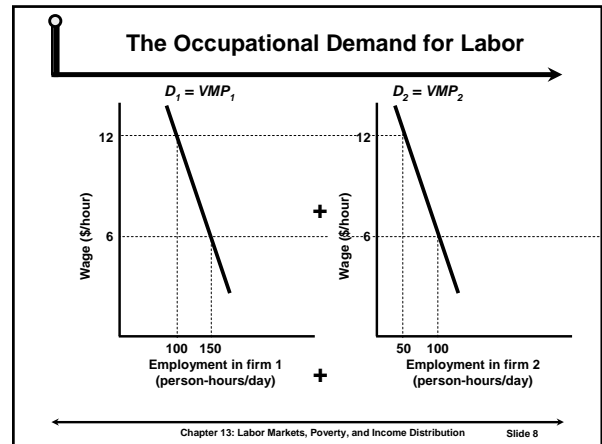
Employment and Productivity in a Woodworking Company (when P = \$20)

Number of workers	Total number of cutting boards/week	MP (extra cutting boards/week)	VMP (\$/week)
0	0	30	600
1	30	25	500
2	55	21	420
3	76	18	360
4	94	14	280
5	108		

•Competitive labor market
 •Wage = \$350/wk
 •MP reflects diminish returns
 •If $VMP >$ wage continue to hire

•Adirondack would hire 4 workers
 •At a given wage the number employed depends on:
 •MP of the worker
 •Price of the product

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Explaining Differences in Earnings

- When labor markets are competitive, differences in wages are determined by differences in $VMPs$.

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Explaining Differences in Earnings

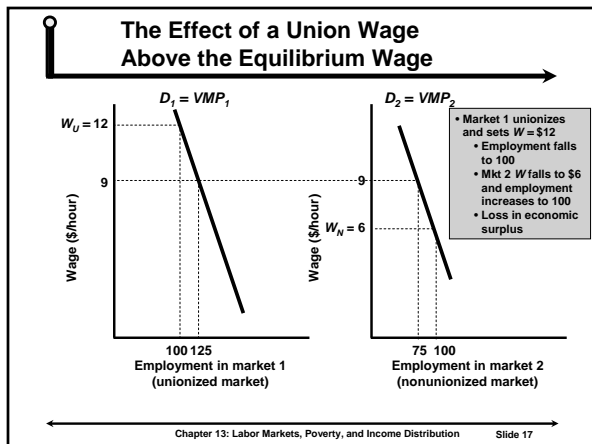
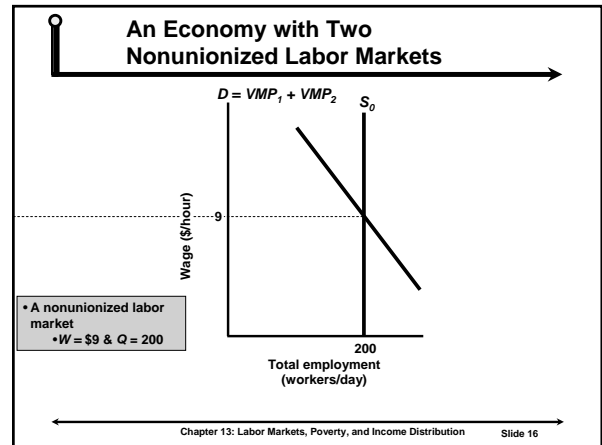
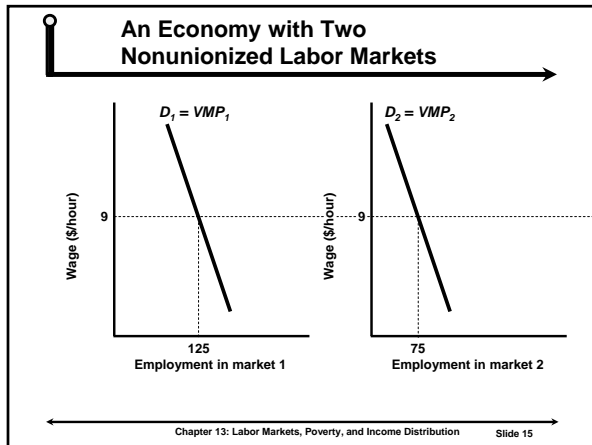
- Explaining Differences in *VMPs*
 - Human Capital
 - ◆ An amalgam of factors such as education, training, experience, intelligence, energy, work habits, trustworthiness, and initiative that affect the value of a worker's marginal product.

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Explaining Differences in Earnings

- Explaining Differences in *VMPs*
 - Human Capital Theory
 - ◆ A theory of pay determination that says a worker's wage will be proportional to his or her stock of human capital
 - Changes in demand can influence the value of human capital.

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Explaining Differences in Earnings

- Compensating Wage Differentials
 - The wage rate depends on the *VMP* and the working conditions.

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Explaining Differences in Earnings

- **Compensating Wage Differential**
 - The differences in the wage rate -- positive or negative -- that reflects the attractiveness of a job's working conditions
 - Examples
 - ◆ Job safety
 - Police and fire-fighters
 - ◆ Schedules
 - Day vs. night
 - Teachers

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Explaining Differences in Earnings

- **Discrimination in the Labor Market**
 - Competitive labor theory predicts that wage differentials not based on differences in *VMP* will be eliminated.
 - However, women and minorities continue to receive lower wages than white males with similar measures of human capital.

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Explaining Differences in Earnings

- **Discrimination by Employers**
 - An arbitrary preference by an employer for one group of workers over another

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Explaining Differences in Earnings

- **Discrimination by Employers**
 - Assume
 - ◆ Male and female employees are equally productive.
 - ◆ An employer prefers to hire male employees.
 - ◆ Male employees are paid more.

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Explaining Differences in Earnings

- **Discrimination by Employers**
 - Then:
 - ◆ The discriminating firm's profit will be less.
 - ◆ Firms employing females will be more profitable.
 - ◆ The demand for females will increase and female wage rates will rise until it equals the wage for males and the *VMP*.
 - ◆ To discriminate, the employers would pay males a wage that is greater than their *VMP* and reduce their profit.

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Explaining Differences in Earnings

- **Discrimination by Others**
 - Customer Discrimination
 - ◆ The willingness of consumers to pay more for a product produced by members of a favored group, even if the quality of the product is unaffected.

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Explaining Differences in Earnings

- Other Sources of the Wage Gap
 - Willingness to accept risk
 - Quality versus quantity of education
 - Courses taken and degrees pursued by sex and race

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Explaining Differences in Earnings

- Winner-Take-All Markets
 - One in which small differences in human capital translate into large differences in pay

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Mean Income Received by Families in Each Income Quintile and by the Top 5 Percent of Families, 1980-2000 (2000 dollars)

Quintile	1980	1990	2000
Bottom 20 percent	\$ 12,756	\$ 12,625	\$ 14,232
Second 20 percent	27,769	29,448	32,268
Middle 20 percent	41,950	45,352	50,925
Fourth 20 percent	58,200	65,222	74,918
Top 20 percent	97,991	121,212	155,527
Top 5 percent	139,302	190,187	272,349

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Recent Trends in Inequality

- Observations
 - From WWII to the 1970s income growth was almost 3%/yr for all groups.
 - From 1980-2000 the income growth of the bottom 20% was less than half of 1%.
 - Real income of the top 1% more than doubled from 1980 - 2000.

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Recent Trends in Inequality

- Observations
 - In 1980, CEOs earned 42 times as much as the average worker; today they earn 500 times as much.
 - The U.S. has a high degree of upward and downward economic mobility.

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Why is Income Inequality a Moral Problem?

- Choosing the Rules for Distributing Income
 - Assume
 - ◆ A "veil of ignorance"
 - ◆ National income is fixed
 - ◆ Most people are risk adverse
- How should income be allocated?

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Why is Income Inequality a Moral Problem?

- What would happen to the incentive to work if everyone was guaranteed an equal amount of income?
- Rewards for hard work and risk taking raise national income.
- Such rewards lead to inequality.

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Why is Income Inequality a Moral Problem?

- The inequality created by a market system may be inefficient if people would choose less inequality when choosing distributional rules from behind a “veil of ignorance.”

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Methods of Income Redistribution

- Difficulties in Developing Programs to Reduce Income Inequality
 - Identifying who will receive benefits
 - Undermining the incentive to work

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Methods of Income Redistribution

- Welfare Payments and In-kind Transfers
 - Assistance to the poor includes:
 - ◆ Cash transfers
 - ◆ In-kind transfers

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Methods of Income Redistribution

- Welfare Payments and In-kind Transfers
 - Aid to Families with Dependent Children (AFDC)
 - ◆ Federal Cash Transfer Program
 - ◆ Criticisms
 - Created an incentive for the father to leave the household
 - Reduced the incentive to work

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Methods of Income Redistribution

- Welfare Payments and In-kind Transfers
 - 1996 Personal Responsibility Act
 - ◆ Responsibility of welfare transferred to the states
 - ◆ States receive a lump-sum payment from the federal government
 - ◆ Five-year lifetime limit on receipt of benefits

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Methods of Income Redistribution

- Means-Tested Benefit Programs
 - Benefit level declines as the recipient earns additional income
 - May make people better off if they do not work
 - Costly to administer

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Methods of Income Redistribution

- The Negative Income Tax (NIT)
 - Every person would receive a tax credit.
 - A person with no income would receive the credit in cash.
 - People who earn income would receive the tax credit and pay taxes on their income at less than 100%.

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Methods of Income Redistribution

- The Negative Income Tax (NIT)
 - Advantages
 - ◆ Incentive to work
 - ◆ Lower administrative cost

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Methods of Income Redistribution

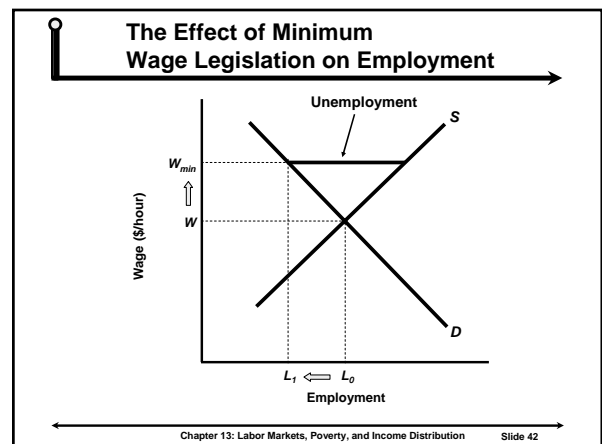
- The Negative Income Tax (NIT)
 - An Example
 - ◆ Poverty threshold in 2001 = \$18,000 for a family of four living in a city.
 - ◆ Assume the NIT credit = \$18,000.
 - ◆ Eight families pool their payments (\$144,000) and move to a rural location and produce their own food.

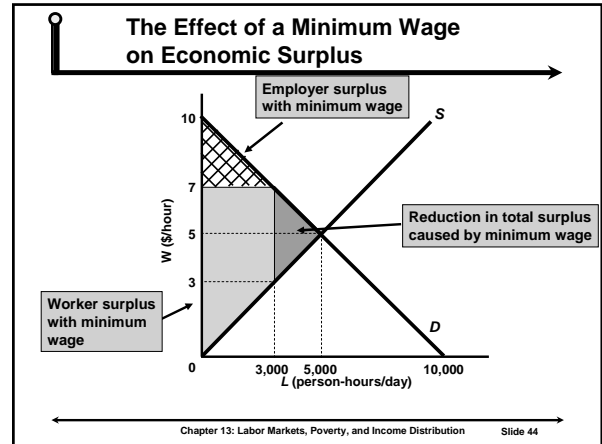
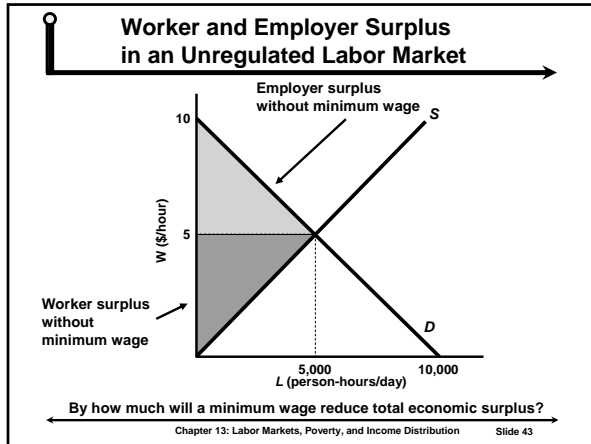
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Methods of Income Redistribution

- The Negative Income Tax (NIT)
 - An Example
 - ◆ Creates an incentive not to work.
 - ◆ The political cost is high because the NIT guarantees income to all who do not work.

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- ### Methods of Income Redistribution
- The Earned-Income Tax Credit (EITC)
 - A policy under which low-income workers receive credits on their federal income tax
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- ### Methods of Income Redistribution
- Example (continued)
 - Using an Earned-Income Tax Credit
 - ◆ With no minimum wage, employment = 5,000 person-hours/day
 - ◆ Workers get paid \$5/hr
 - ◆ Worker surplus is \$4,000/day less than with the minimum wage
 - ◆ The tax credit would be \$0.80/hr for 5,000 person hours/day
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- ### Methods of Income Redistribution
- Example
 - If the EITC were financed by a \$4,000 tax on employers, employer surplus would be \$4,000 greater than under the \$7 minimum wage.
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- ### Methods of Income Redistribution
- Public Employment for the Poor
 - Overcomes the shortcomings of the EITC and NIT
 - ◆ EITC does not help the unemployed
 - ◆ NIT reduces the incentive to work
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Methods of Income Redistribution

- Public Employment for the Poor
 - Disadvantages of public service employment
 - ◆ People may leave private sector jobs.
 - ◆ The output created by the jobs may not have any value.
 - ◆ Increase in government bureaucracy.

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Methods of Income Redistribution

- A Combination of Methods
 - Use a NIT with payment set below the poverty threshold
 - Set the public service wage below the minimum wage
 - Privatize the management of the public service employment program

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