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## Income Distribution and Poverty



# 18

CHAPTER OUTLINE

**The Sources of Household Income**  
 Wages and Salaries  
 Income from Property  
 Income from the Government: Transfer Payments

**The Distribution of Income**  
 Income Inequality in the United States  
 The World Distribution of Income  
 Causes of Increased Inequality  
 Poverty  
 The Distribution of Wealth

**The Utility Possibilities Frontier**

**The Redistribution Debate**  
 Arguments Against Redistribution  
 Arguments in Favor of Redistribution

**Redistribution Programs and Policies**  
 Financing Redistribution Programs: Taxes  
 Expenditure Programs

**Government or the Market? A Review**

**equity** Fairness.

This chapter focuses on distribution.

Why do some people get more than others?

What are the sources of inequality?

Should the government change the distribution generated by the market?

## The Sources of Household Income

### Wages and Salaries

There are reasons why one type of labor might be more productive than another and why some households have higher incomes than others.

Required Skills, Human Capital, and Working Conditions

**human capital** The stock of knowledge, skills, and talents that people possess; it can be inborn or acquired through education and training.

**compensating differentials** Differences in wages that result from differences in working conditions. Risky jobs usually pay higher wages; highly desirable jobs usually pay lower wages.

Multiple Household Incomes

Another source of wage inequality among households lies in the fact that many households have more than one earner in the labor force. Second, and even third, incomes are becoming more the rule than the exception for U.S. families.



Which of the following jobs is more likely to pay a *compensating differential*?

- a. Waiter.
- b. Lawyer.
- c. Professor.
- e. Mine detonator.
- d. Insurance salesman.

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- d. Insurance salesman.



How do wealth and income rate as measures of well-being?

- a. We use wealth and income to measure well-being because they are good, direct measures of it.
- b. Wealth and income are both indirect, imperfect measures of well-being.
- c. Wealth is a better measure of well-being than income.
- d. Income is a better measure of well-being than wealth.
- e. We use wealth and income to measure well-being, but, if necessary, we could substitute them for other measures of well-being that are equally accurate.

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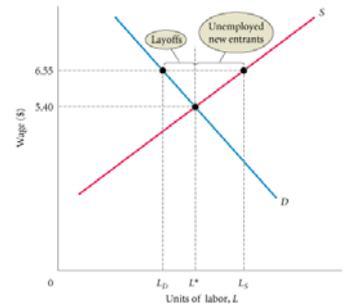
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The Minimum Wage Controversy

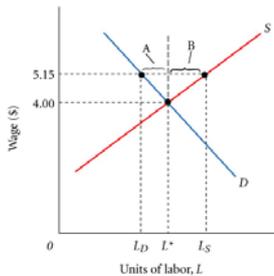
**minimum wage** The lowest wage that firms are permitted to pay workers.

► **FIGURE 18.1 Effect of Minimum Wage Legislation**

If the equilibrium wage in the market for unskilled labor is below the legislated minimum wage, the result is likely to be unemployment. The higher wage will attract new entrants to the labor force (quantity supplied will increase from  $L^*$  to  $L_S$ ), but firms will hire fewer workers (quantity demanded will drop from  $L^*$  to  $L_D$ ).

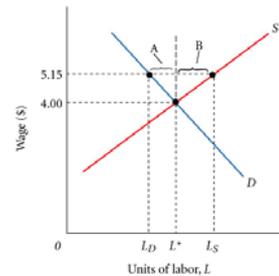


Refer to the figure below. After a minimum wage of \$5.15 is imposed on this labor market, which segment represents layoffs?



- a. Segment A.
- b. Segment B.
- c. Segments A and B.
- d. The vertical distance between \$4.00 and \$5.15.

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- a. **Segment A.**
- b. Segment B.
- c. Segments A and B.
- d. The vertical distance between \$4.00 and \$5.15.

## Unemployment

Unemployment hurts primarily those who are laid off, and thus its costs are narrowly distributed.

For some workers, the costs of unemployment are lowered by unemployment compensation benefits paid out of a fund accumulated with receipts from a tax on payrolls.

## Income from Property

**property income** Income from the ownership of real property and financial holdings. It takes the form of profits, interest, dividends, and rents.

The amount of property income that a household earns depends on (1) how much property it owns and (2) what kinds of assets it owns. Such income generally takes the form of profits, interest, dividends, and rents.

Households come to own assets through saving and through inheritance.

## Income from the Government: Transfer Payments

**transfer payments** Payments by government to people who do not supply goods or services in exchange.

The biggest single transfer program at the federal level is Social Security.

Transfer programs are by and large designed to provide income to those in need. They are part of the government's attempts to offset some of the problems of inequality and poverty.

Transfer payments tend to rise when the overall economic growth is low as it was in the 2008 to 2012 period.

## ECONOMICS IN PRACTICE

### Everything I Needed to Know I Learned in Kindergarten!

Recent work tells us that what matters is not just how much education you get, but what that education was like. In particular, it seems to matter a good deal how good your teachers were.

A group of economists examined the careers of 11,000 students who had taken part in an education program in Tennessee in the late 1980s. Moving from a class taught by a below average teacher to one at the 75th percentile increased later earnings by 3.5 percent per year!

Teacher quality mattered more than many people expected, and the results emerge many years later in people's wages.

### THINKING PRACTICALLY

1. What does this study tell us about one of the possible sources for wage inequality in the United States?

## The Distribution of Income

**economic income** The amount of money a household can spend during a given period without increasing or decreasing its net assets. Wages, salaries, dividends, interest income, transfer payments, rents, and so on are sources of economic income.

Economic income includes anything that enhances your ability to spend.

If you own an asset (such as a share of stock) that increases in value, that gain is part of your income whether or not you sell the asset to "realize" the gain.

Normally, we speak of "before-tax" income, with taxes considered a use of income.

## Income Inequality in the United States

**TABLE 18.1** Distribution of Total Income and Components in the United States, 2006 (Percentages)

| Households    | Total Income | Labor Income | Property Income | Transfer Income |
|---------------|--------------|--------------|-----------------|-----------------|
| Bottom fifth  | 3.4          | 1.3          | 2.2             | 17.2            |
| Second fifth  | 9.2          | 6.7          | 6.3             | 24.6            |
| Third fifth   | 16.3         | 14.1         | 11.7            | 21.2            |
| Fourth fifth  | 23.6         | 24.5         | 14.3            | 18.3            |
| Top fifth     | 47.5         | 53.4         | 65.5            | 18.7            |
| Top 1 percent | 13.2         | 10.8         | 30.6            | 1.0             |

In 2006, the top quintile earned 47.5 percent of total income while the bottom quintile earned just 3.4 percent. The top 1 percent (which is part of the top quintile) earned more than the bottom 40 percent. Labor income was less evenly distributed than total income.



In the United States, in recent years, which of the following has been more evenly distributed?

- a. Income from property.
- b. Income from wages and salaries.
- c. Income from transfer payments.
- d. Income as a whole for the United States.

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### Changes in the Distribution of Income

**money income** The measure of income used by the Census Bureau. Because money income excludes noncash transfer payments and capital gains income, it is less inclusive than economic income.

|              | 1967 | 1975 | 1985 | 1995 | 2000 | 2009 | 2011 |
|--------------|------|------|------|------|------|------|------|
| Bottom fifth | 4.0  | 4.3  | 3.9  | 3.7  | 3.6  | 3.4  | 3.2  |
| Second fifth | 10.8 | 10.4 | 9.8  | 9.1  | 8.9  | 8.6  | 8.4  |
| Third fifth  | 17.3 | 17.0 | 16.2 | 15.2 | 14.8 | 14.6 | 14.3 |
| Fourth fifth | 24.2 | 24.7 | 24.4 | 23.3 | 23.0 | 23.2 | 23.0 |
| Top fifth    | 43.6 | 43.6 | 45.6 | 48.7 | 49.8 | 50.3 | 51.1 |
| Top 5%       | 17.2 | 16.4 | 17.6 | 21.6 | 22.1 | 21.7 | 22.3 |

Since 1975, there has been a slow but steady drift toward more inequality. During those years, the share of income going to the top 5 percent has increased from 16.4 percent to 22.3 percent while the share going to the bottom 40 percent has fallen from 14.7 percent to 11.6 percent.

### The Lorenz Curve and the Gini Coefficient

**Lorenz curve** A widely used graph of the distribution of income, with cumulative percentage of households plotted along the horizontal axis and cumulative percentage of income plotted along the vertical axis.

**Gini coefficient** A commonly used measure of the degree of inequality of income derived from a Lorenz curve. It can range from 0 to a maximum of 1.



A Gini coefficient equal to zero means:

- a. An equal distribution of income.
- b. The most unequal distribution of income possible.
- c. A society where the distribution of income cannot be considered either equal nor unequal.
- d. None of the above. The Gini coefficient can never be zero.

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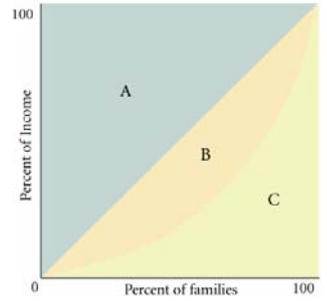
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The Lorenz Curve and the Gini Coefficient



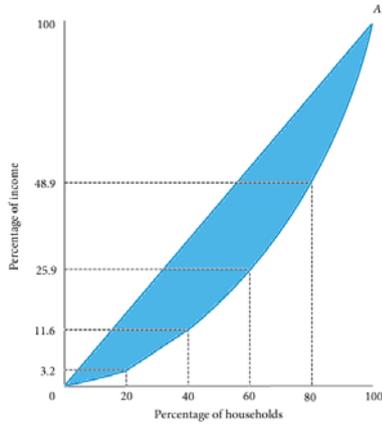
Refer to the graph below. What happens in this graph when society achieves a perfect distribution of income?

- a. Area A disappears.
- b. Area B disappears.
- c. Area C disappears.
- d. All areas become one.
- e. Nothing happens.



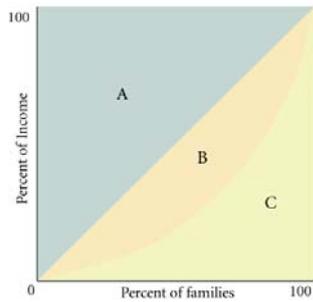
► FIGURE 18.2 Lorenz Curve for the United States, 2009

The Lorenz curve is the most common way of presenting income distribution graphically. If the distribution were equal, the Lorenz curve would be the 45-degree line OA. The larger the shaded area, the more unequal the distribution.



Refer to the graph below. What happens in this graph when society achieves a perfect distribution of income?

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- b. **Area B disappears.**
- c. Area C disappears.
- d. All areas become one.
- e. Nothing happens.



Differences Among African-American Households, White Households, and Hispanic Households

TABLE 18.3 Mean Household Income Received by the Top, Middle, and Bottom Fifth of Households in 2011

|            | White (non-Hispanic) | African-American | Hispanic |
|------------|----------------------|------------------|----------|
| Bottom 20% | \$ 12,691            | \$ 6,263         | \$ 9,194 |
| Middle 20% | 52,643               | 32,632           | 38,543   |
| Top 20%    | 183,853              | 125,583          | 130,083  |
| Top 5%     | 321,651              | 216,220          | 218,124  |

In 2011, the bottom 20 percent of white households had a mean household income that was twice that of the bottom 20 percent of African-American households.

For the middle 20 percent of households, mean income for white households was 61 percent higher than mean income for African-American households. For Hispanics, the figure was 36 percent.

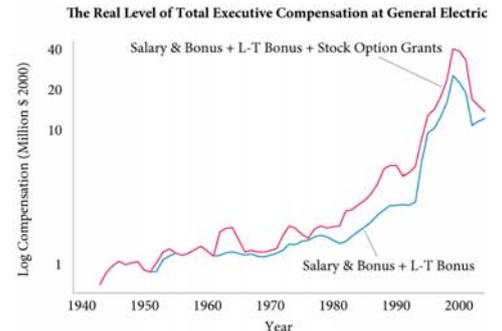
The top 5 percent of white households averaged \$321,651 of income. For African-Americans, it was \$216,220; for Hispanics, \$218,124.

ECONOMICS IN PRACTICE

The New Rich Work!

The chart shows the dramatic increases in real executive pay over the post-war period.

Executive compensation has increased across a wide swath of firms, while the real wage of the average worker has stagnated.



THINKING PRACTICALLY

1. Executive compensation is much higher in the United States than elsewhere in the world. Can you think of any causes for this?

The World Distribution of Income

TABLE 18.4 Income and Income per Capita Across the World in 2008

|                         | Population |     | Gross National Income |       | Per-Capita Income |
|-------------------------|------------|-----|-----------------------|-------|-------------------|
|                         | Billions   | %   | Trillions of \$       | %     | (Dollars)         |
| World                   | 6.7        | 100 | 57.6                  | 100.0 | 8,613             |
| Low-Income Countries    | 1.0        | 15  | 0.5                   | 1.0   | 524               |
| Middle-Income Countries | 4.6        | 70  | 15.2                  | 26.0  | 3,260             |
| High-Income Countries   | 1.1        | 15  | 42.0                  | 73.0  | 39,345            |

When you look at total national income, the rich countries with 15 percent of the population earn 73.0 percent of world income, while the poor countries with 15 percent of the population get only 1.0 percent of world income.

## Causes of Increased Inequality

What has caused the rise in inequality?

Is it the forces of free trade, immigration, and globalization all working together to worsen the position of the middle-income workers who find themselves competing with workers in lower-income countries? Is it the declining power of unions and deregulation that have opened up more labor markets to the forces of competition? Is it technological change that has favored the well-educated worker at the expense of unskilled labor? These are difficult questions debated across the world.

Empirical evidence of the extent to which immigration has in fact reduced wages of lower-income workers is mixed.

### The Evidence: The Net Costs of Immigration

To determine whether the net benefits of immigration outweigh its net costs, we must ask one important question: To what extent does immigration reduce domestic wages and increase unemployment? Going forward, education may be key to reducing inequality in the United States and across the world.

## Poverty

*Poverty* is a very complicated word to define. In simplest terms, it means the condition of people who have very low incomes.

### The Problem of Definition

One school of thought argues that poverty should be measured by determining how much it costs to buy the “basic necessities of life.”

Some say that poverty is culturally defined and is therefore a relative concept, not an absolute one.

Although it is difficult to define precisely, the word *poverty* is one that we all understand intuitively to some degree. It is also a word that we have been forced to define formally for purposes of keeping statistics and administering public programs.

## Poverty

### The Official Poverty Line

**poverty line** The officially established income level that distinguishes the poor from the nonpoor. It is set at three times the cost of the Department of Agriculture’s minimum food budget.

### Poverty in the United States Since 1960

TABLE 18.5 Percentage of Persons in Poverty by Demographic Group, 1964 and 2009

|                                       | Official Measure 1964 | Official Measure 2009 |
|---------------------------------------|-----------------------|-----------------------|
| All                                   | 19.0                  | 14.3                  |
| White (Non-Hispanic)                  | 14.9                  | 9.4                   |
| Black                                 | 49.6                  | 25.8                  |
| Hispanic                              | NA                    | 25.3                  |
| Female householder—no husband present | 45.9                  | 29.9                  |
| Elderly (65 +)                        | 28.5                  | 8.9                   |
| Children under 18                     | 20.7                  | 20.7                  |

The poverty rate among African-Americans is more than twice as high as the poverty rate among whites. Nearly one in four African-Americans live in poverty. In addition, a slightly lower proportion of Hispanics than African-Americans had incomes below the poverty line in 2009.

The group with the highest incidence of poverty in 2009 was women living in households with no husband present.

Poverty rates among the elderly have been reduced considerably over the last few decades, dropping from 28.5 percent in 1964 to 8.9 percent in 2009.



Which of the following statements about the statistics of poverty is/are true?

- Poverty in the United States has been steadily reduced after the 1960s.
- The official count of people in poverty tends to understate the true number.
- Poverty among the elderly has been reduced considerably over the last few decades.
- Poverty tends to be widespread, with no substantial differences between groups of the population.
- All of the above.

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- All of the above.

## ECONOMICS IN PRACTICE

### Intergenerational Inequality

Born the son or daughter of someone in the bottom twenty percent of the distribution, how likely is it you will move into the top?

A number of papers tell us more or less the same story: intergenerational mobility is very hard. One of the best predictors of a young person’s future place in the income distribution is the place occupied by his or her parents.

And there is some indication that mobility varies across countries. Despite a reputation as a land of opportunity, the United States has lower mobility than the Nordic countries or Canada. Indeed, recent work suggests that Canadian earnings mobility is three times that of the United States.

Understanding why children seem to “inherit” their parents’ socioeconomic status is an important question for many social scientists and policy makers.

### THINKING PRACTICALLY

- Given what you have read thus far, can you suggest a few factors that might impede intergenerational mobility?

## The Distribution of Wealth

Data on the distribution of wealth are not as readily available as data on the distribution of income.

The distribution of wealth is more unequal than the distribution of income.

Some argue that an unequal distribution of wealth is the natural and inevitable consequence of risk taking in a market economy: It provides the incentive necessary to motivate entrepreneurs and investors.

Others believe that too much inequality can undermine democracy and lead to social conflict.

Many of the arguments for and against income redistribution apply equally well to wealth redistribution.

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## The Utility Possibilities Frontier

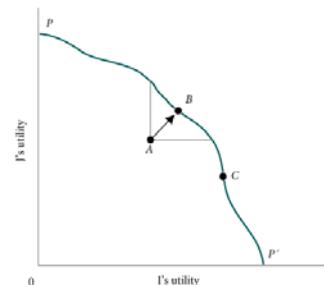
► **FIGURE 18.3 Utility Possibilities Frontier**

If society were made up of two people, I and J, and all the assumptions of perfect competition held, the market system would lead to some point along  $PP'$ .

Every point along  $PP'$  is efficient; it is impossible to make I better off without making J worse off, and vice versa.

Which point is best?

Is  $B$  better than  $C$ ?



**utility possibilities frontier** A graphic representation of a two-person world that shows all points at which I's utility can be increased only if J's utility is decreased.

## The Redistribution Debate

### Arguments Against Redistribution

Those who argue against government redistribution believe that the market, when left to operate on its own, is fair—that “one is entitled to the fruits of one's efforts.”

### Arguments in Favor of Redistribution

The argument most often used in favor of redistribution is that a society as wealthy as the United States has a moral obligation to provide all its members with the necessities of life.

In declaring war on poverty in 1964, President Lyndon Johnson put it this way:

There will always be some Americans who are better off than others. But it need not follow that the “poor are always with us.”...It is high time to redouble and to concentrate our efforts to eliminate poverty....We know what must be done and this nation of abundance can surely afford to do it.

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### Utilitarian Justice

**utilitarian justice** The idea that “a dollar in the hand of a rich person is worth less than a dollar in the hand of a poor person.” If the marginal utility of income declines with income, transferring income from the rich to the poor will increase total utility.

### Social Contract Theory—Rawlsian Justice

**Rawlsian justice** A theory of distributional justice that concludes that the social contract emerging from the “original position” would call for an income distribution that would maximize the well-being of the worst-off member of society.

## The Works of Karl Marx

Marx did not write very much about socialism or communism. His major work, *Das Kapital* (published in the nineteenth century), was a three-volume analysis and critique of the capitalist system that he saw at work in the world around him.

**labor theory of value** Stated most simply, the theory that the value of a commodity depends only on the amount of labor required to produce it.

### Income Distribution as a Public Good

Private charity may fail for the same reason that the private sector is likely to fail to produce national defense and other public goods.

People will find it in their interest not to contribute.

We turn to government to provide goods and services we want that will not be provided adequately if we act separately.

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Which of the following statements is/are correct?

- The works of Marx were mostly a roadmap for the construction of a socialist economy.
- Marx was the first to point out that capital, like labor, is productive and has a marginal product.
- Marx saw profit as an illegitimate expropriation by capitalists of the fruits of labor's efforts.
- Marxism is now antiquated and no longer a powerful force in the world today.
- All of the above.

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- d. Marxism is now antiquated and no longer a powerful force in the world today.
- e. All of the above.

## Redistribution Programs and Policies

### Financing Redistribution Programs: Taxes

The role of government in changing the distribution of income is hotly debated. Redistribution always involves those who end up with less and those who end up with more.

Because redistributive programs are financed by tax dollars, it is important to know who the donors and recipients are—who pays the taxes and who receives the benefits of those taxes.

**TABLE 18.6 Effective Rates of Federal, State, and Local Taxes, 2000 (Taxes as a Percentage of Total Income)**

|            | Federal | Total |
|------------|---------|-------|
| Bottom 20% | 5.9     | 28.1  |
| Second 20  | 11.7    | 26.3  |
| Third 20   | 17.4    | 29.2  |
| Fourth 20  | 20.1    | 32.6  |
| Top 20     | 24.6    | 33.9  |
| Top 10     | 25.7    | 34.5  |
| Top 5      | 26.6    | 34.9  |
| Top 1      | 29.1    | 37.0  |

### Supplemental Security Income

The *Supplemental Security Income program (SSI)* is a federal program financed out of general revenues that was set up under the Social Security Administration in 1974.

SSI is designed to take care of the elderly who end up very poor and have no or very low Social Security entitlement.

As with welfare, qualified recipients must have very low incomes and virtually no assets.

### Unemployment Compensation

**unemployment compensation** A state government transfer program that pays cash benefits for a certain period of time to laid-off workers who have worked for a specified period of time for a covered employer.

### Housing Programs

Over the years, the federal government and state governments have administered many different housing programs designed to improve the quality of housing for low-income people.

The largest housing program, called "Section 8," provides housing assistance payments to tenants and slightly above-market rent guarantees to participating landlords.

### The Earned Income Tax Credit

A complex program, the EIC essentially allows lower-income families with children a credit equal to a percentage of all wage and salary income against their income taxes.

### Expenditure Programs

#### Social Security

**Social Security system** The federal system of social insurance programs. It includes three separate programs that are financed through separate trust funds: the Old Age and Survivors Insurance (OASI) program, the Disability Insurance (DI) program, and the Health Insurance (HI), or Medicare program.

#### Public Assistance

**public assistance, or welfare** Government transfer programs that provide cash benefits to: (1) families with dependent children whose incomes and assets fall below a very low level and (2) the very poor regardless of whether they have children.

#### Health Care: Medicaid and Medicare

**Medicaid and Medicare** In-kind government transfer programs that provide health and hospitalization benefits: Medicare to the aged and their survivors and to certain of the disabled, regardless of income, and Medicaid to people with low incomes.

#### Supplemental Nutrition Assistance Program (SNAP)

The SNAP program (formerly called the Food Stamp Program) is an antipoverty program fully funded out of general federal tax revenue, with states bearing 50 percent of the program's administrative costs.

In 2012, about 47 million people in the United States received SNAP benefits. The cost of the program in 2012 was about \$80 billion.

## ECONOMICS IN PRACTICE

### Expanding Medicare is Complicated

Medicare Part D subsidizes private prescription drug plans, which in turn contract with pharmaceutical companies to buy needed drugs.

In a recent paper Mark Duggan and Fiona Scott Morton investigated the effects of the Part D program on pharmaceutical prices.

The coverage brings previously uninsured people into the market since their purchases are now subsidized. If pharmaceutical companies have some market power, we would expect drug prices to go up as result. But the government also has power over the pharmaceutical companies and can threaten to exclude a company's drugs from an approved list. This power would tend to push down prices.

The results? Duggan and Scott Morton find that the bargaining power dominates and Part D actually decreases pharmaceutical prices, thus benefitting not only those enrolled in Part D but all others who buy some of the same drugs.

#### THINKING PRACTICALLY

1. What type of drugs do you think see the biggest price decreases?

## Government or the Market? A Review

Some firms acquire market power and tend to underproduce and overprice.

Unregulated markets give private decision makers no incentives to weigh the social costs of externalities.

Goods that provide collective benefits may not be produced in sufficient quantities without government involvement.

The final distribution of well-being determined by the unfettered market may not be considered equitable by society.

Remember still that government is not a cure for all economic woes.

There is no guarantee that public-sector involvement will improve matters.

Many argue that government involvement may bring about even more inequity and inefficiency because bureaucrats are often driven by self-interest, not public interest.

## ECONOMICS IN PRACTICE

### Will Obamacare Make You Healthier?

Will President Obama's health care bill lead to better access to public health? How will this program affect previously uninsured low-income adults?

An experiment in 2008 in Oregon has allowed a group of economists to provide some evidence. Finding itself with enough resources to enroll an additional 10,000 people, Oregon decided to hold a lottery to allocate the slots.

Finkelstein and her team could simply compare what happened to those who got the coverage with those who did not.

The results? After one year, the team found, not surprisingly, higher health care utilization (price matters!), but less medical debt and better self reported health. They further found more use of preventive care, but found no evidence of declines in the use of emergency rooms, which many advocates of universal health insurance would have predicted.

#### THINKING PRACTICALLY

1. Why would advocates of universal health care have expected emergency room visits to fall?

## REVIEW TERMS AND CONCEPTS

|                            |                                |
|----------------------------|--------------------------------|
| compensating differentials | money income                   |
| economic income            | poverty line                   |
| equity                     | property income                |
| food stamps                | public assistance, or welfare  |
| Gini coefficient           | Rawlsian justice               |
| human capital              | Social Security system         |
| labor theory of value      | transfer payments              |
| Lorenz curve               | unemployment compensation      |
| Medicaid and Medicare      | utilitarian justice            |
| minimum wage               | utility possibilities frontier |