Chapter 12. Income redistribution

This chapter presents a framework for thinking about the normative and positive aspects of government income redistribution policy.
A way to distribute income is to compute the number of people below the **poverty line**; a fixed level of real income considered enough to provide a minimally adequate standard of living.
First, it is important to see why there are large disparities in income. Within the developed countries, wage differentials are the most important reason. Differences in property income (interest, dividends) account for only a small portion of income inequality. A key factor driving the increase in inequality is an increase in the financial returns to education.
Measuring the extent of poverty is hard to do. It is therefore very important to know the conventions use to construct the income data:

1. The income is based on cash-receipts and **in-kind transfers** – payments in commodities or services as opposed to cash.
2. The official figures ignore taxes. Tax redistribution is not reflected in the numbers.
3. Income is measured annually. However, even annual measures may not reflect an individual's true economic position. Income can fluctuate.
4. There are problems in defining the unit of observation. The figures ignore changes in household composition. It is hard to account for economies of scale. The data may provide a better assessment of well-being than it is in practice.

Welfare economics posits that society's welfare depends on the well-being of its members. This means welfare is a function of all individuals' utilities (**utilitarianism**):

Utilitarian social welfare function: **W = F(U1,U2, … , Un)**

A change that makes someone better off without making anyone else worse off increases social welfare. Income should be redistributed as long as it increases W.

Additive social welfare function: **W = U1 + U2 + … + Un**

If: (1) Individuals have identical utility functions only depending on income
(2) Marginal utility of income diminishes
(3) Total income is fixed

Then the government should redistribute income so as to obtain complete equality.

However, these are strong assumptions and weakening them gives radically different results. Obviously, you can question the assumptions:

- It is a reasonable guess that utility functions are identical, but they do not only depend on income (often also on for instance leisure). So it is impossible to know whether utility functions are identical.
- It is probably that marginal utility of income diminishes. If it does not, the redistribution cannot change social welfare.
- Total amount of income is not fixed. If an individual's utility depends on leisure, redistribution makes working less attractive, so there is less income to redistribute.

The additive social welfare function assumed that society is indifferent to the distribution of utilities. Not every utilitarian social welfare function carries this implication:
Maximin criterion: **$W = \text{Minimum}(U1, U2, \dots, Un)$**

In this equation, social welfare depends only on the utility of the person who has the lowest utility. The best income distribution maximizes the utility of the person who has the lowest utility. This means society's only concern is the poorest person.

John Rawls claimed that the maximin criterion has a claim to ethical validity. If people are risk-averse and do not know their future position in society (**original position**), they will choose maximin as an insurance against disastrous outcomes. However, the analysis is controversial, because the welfare of other persons also matters and people are not always totally risk-averse. Because of the assumption that each individual's utility depends only on income, redistribution was never a Pareto improvement. Redistribution can actually be a Pareto improvement:

- If high income individuals are altruistic, their utilities depend not only on their incomes but those of the poor as well. Income redistribution can be seen as a public good – everyone derives utility from the redistribution, but government coercion is needed to accomplish redistribution.
- There is always some chance that you will become poor. An income distribution policy is a bit like an insurance against future poverty.
- Income distribution creates social stability. If poor people become too poor, the may engage in antisocial activities such as crime.

After deciding whether the government should redistribute income, the next question is how to do it. The government influences income redistribution through its taxation as well as its expenditure policies. The impact of expenditure policy on the redistribution of real income is referred to as **expenditure incidence**. This is difficult to determine, because of:

- **Relative price effects**
  An expenditure programme sets off a chain of price changes that affects the income of people both in their role as consumers of goods and as suppliers of inputs. The problem is that it is very hard to trace all the price changes. Economists generally focus on the prices in the markets that are directly affected.
- **Public goods**
  For public goods, the impact on the income distribution is unknown, because people do not reveal how they value public goods.
- **In-kind transfers**
  Many government programs provide goods and services instead of cash. If recipients would prefer to consume less, the value of the in-kind transfer is less than the market price. We cannot know for certain if an in-kind transfer is valued less than a direct income transfer. The answer has to be found by empirical analysis. Another problem is that in-kind transfers often entail substantial administrative costs, which reduces efficiency.

Reasons for in-kind transfers:

- **Paternalism**
  Politicians seem to know better what is good for people.
- **Commodity egalitarianism**
  Only special commodities must be equally accessible to everyone.
- **Administrative feasibility**
  An in-kind transfer leads to less fraud than with a money transfer. In-kind transfers may discourage ineligible persons from applying because they are less willing to lie to obtain a commodity they do not really want.
- **Political attractiveness**
  In-kind transfers help not only the beneficiary but also the producers of the favoured commodity.