

VIII. Income Redistribution

How the Free Market Distributes Income

Primary means of earning income: sale of factors of production

- Labor income =
- Capital income =

Adv. Of free market income distrib.

- Paying each factor its MP rewards initiative, effort, risk-taking
- On average, the harder, longer, more efficiently a person works, the more he is paid
- If individual risks his funds on a risky venture & succeeds, he gets big dividend.

Disadv. of free market income distrib.

- Can generate a lot of inequality since some have lower MP
- Luck plays a large role
Example:
- People with low MP have few choices, even survival problems

Society has values besides efficiency: Human Dignity

- Society should intervene when survival is at stake.
- All other things equal, society prefers more equality.

But there is often a trade-off between
efficiency and equality

Questions we face:

What is a "Just" Distribution of Income?

We will consider 2 philosophical criteria

1. The Rawls Criterion

Example:

2 people deciding between 2 different societies:

Society X: Position 1 wealth = \$1,000,000

Position 2 wealth = \$1

Society Y: Position 1 wealth = \$50,000

Position 2 wealth = \$50,000

Formal Rawls Criterion

Maximin Criterion: Choose the society that max utility of the person in the worst position.

Spse $x = (x_1, x_2, \dots, x_n)$ & $y = (y_1, y_2, \dots, y_n)$ are 2 distrib. of income among n people

We say that x is **Rawls Superior** to y if

Properties of Rawls Criterion

- Among distrib. of fixed total wealth c among n people, the Rawls superior distrib. is $(c/n, c/n, \dots, c/n)$
- If choices are being made among distrib. w/o fixed totals, the RC can be perversely oversollicitous to the worst off person.

Example

$X = (50, 100, 150)$, total income = 300

$Y = (90, 90, 90)$, total income = 270

$Z = (80, 250, 250)$, total income = 580

Harsanyi's Expected Utility Criterion

Idea: Harsanyi agrees with Rawls "veil of ignorance" but instead of maximin, we should max. EU.

Example:

Should We Strive to Equalize Outcomes or Opportunities?

1. Equalizing Outcomes: (meaning redistributing income or goods)

Advantage:

Disadvantage of Equalizing Outcomes:

2. Equalizing Opportunities

Examples:

Advantage:

Disadvantages:

Causes of Poverty

1. Recession
2. Low skills
3. Structural change
in economy
4. Personal factors