

# Homework 5

ECON 380  
UNC Chapel Hill

Name: \_\_\_\_\_

ONYEN: \_\_\_\_\_

This homework is due on **October 31** by **2:15PM**. You must turn in your work on a printed copy of this document in order for it to be graded. Your assignment must be stapled and in the correct order. Non-stapled assignments will automatically receive a 10 point deduction. There are a total of 50 available points.

1. (Borjas 7.4) Consider a simple economy where 90 percent of citizens report an annual income of \$10,000 while the remaining 10 percent report an annual income of \$110,000.

(a) What is the Gini coefficient associated with this economy? [4 pts]

(b) Is the presence of an underground economy likely to result in a Gini coefficient that overstates or understates poverty? Why? [4 pts]

(c) Suppose the poorest 90 percent of citizens actually have an income of \$15,000 because each receives \$5,000 of unreported income from the underground economy. What is the Gini coefficient now? [4 pts]

2. There are two people in the Springfield economy: Homer and Burns. Each individual gets utility from consumption:

$$U(C_H) = \sqrt{C_H}$$

$$U(C_B) = \sqrt{C_B}$$

Initially, suppose that Homer produces 10 units of output (hence, with no redistribution, can consume  $C_H = 10$ ) while Burns produces 90 units of output.

- (a) Suppose a “benevolent social planner” is trying to determine the optimal level of redistribution (in other words, how many units of consumption Burns should give to Homer). To do so, this social planner wishes to maximize the sum of the utilities of Homer and Burns. Define “social utility” as **[5 pts]**

$$U_S(C_H, C_B) = \sqrt{C_H} + \sqrt{C_B}$$

For now, assume that redistribution does not affect how much each individual produces: Homer still always produces 10, Burns still always produces 90, and the social planner is simply trying to figure out the best way to distribute 100 units of output. Fill in the empty cells in the following table. Round the “social utility” to the nearest hundredth.

Transfer	Total Production	$C_H$	$C_B$	Social Utility
0	100	10	90	12.65
10	100	20	80	
20				
30				
40				
50				
60				

- (b) What is the optimal transfer from Burns to Homer? What are each respective agents’ consumption levels after the transfer? **[2 pts]**

- (c) A common concern among economists is that redistribution affects incentives, so assuming that Burns and Homer still produce just as much output regardless of the transfer program is flawed: For both Burns and Homer, their respective incomes are only partially determined by their own actions, and partially determined by the others’ actions, which may decrease their individual efforts to produce output. Now, suppose that transfers are costly: For each 10 units transferred, each individual produces one fewer unit of output. For example, if we transfer 10 units of output, then Burns produces 89, Homer produces 9, and final consumption is  $89 - 10 = 79$  for Burns and  $9 + 10 = 19$  for Homer. Fill out the following table, rounding social utility to the nearest hundredth. **[5 pts]**

Transfer	Total Production	$C_H$	$C_B$	Social Utility
0	100	10	90	12.65
10	98	19	79	
20				
30				
40				
50				
60				

- (d) What is the optimal transfer from Burns to Homer (of those listed on the table)? What are each respective agents' consumption levels after the transfer? **[2 pts]**
3. (Borjas 7.11) Suppose two households earn \$40,000 and \$56,000, respectively. What is the expected percent difference in wages among the children, grandchildren, and great-grandchildren of the two households if the intergenerational correlation of earnings is 0.2, 0.4, or 0.6? **[4 pts]**

Directions: Type your answers to the following questions and attach them to the back of this packet.

4. Read the following article: [Bad and Good Inequality by Gary Becker](#)
- (a) What does Becker cite as an example of “good” inequality? Briefly explain why such inequality can create social value. **[4 pts]**
- (b) What does Becker cite as an example of “bad” inequality? **[4 pts]**
- (c) According to Becker, what has happened to global income inequality over the past 30 years? Given that many developed countries have seen inequality become more severe, what can be inferred about the rate of growth in the developing/undeveloped world compared to the rate of growth in the developed world over this timeframe? **[4 pts]**
5. Read the following article: [Separate and Unequal by Thomas Edsall](#)
- (a) Which of the causes of inequality, as discussed in the slides, is most consistent with Stiglitz's views on the factors driving inequality in recent years? **[4 pts]**
- (b) In 3-4 sentences, explain why Stiglitz believes that excessive inequality leads to lower growth and less efficiency. **[4 pts]**