ECO 450G Notes - Spring 2003 Semester – January 21, 2003

Chapter 1 – Views of Inequality and Poverty

I. The Continuing Controversy
II. Causes and Cures
III. Dimensions of Well Being
IV. Poverty: Drawing a Line

I. The Continuing Controversy

This class and the textbook will focus largely on poverty in the United States.

Compared with other countries, the U.S. is very well off economically, even at the bottom of the income distribution.

As Table 1.1 in Schiller shows, there is not much agreement by Americans on what should be done about the poverty "problem." No answer in a 1999 Gallup poll received endorsements by even half of the respondents (respondents could choose more than one answer).

> Around 35% of respondents don't think the government should do anything.
>
> Other popular answers revolve around more education, more skills and training, and more job opportunities.
>
> Less popular answers revolved around more direct government financial aid and/or raising the minimum wage.

II. Causes and Cures

There are three main explanations for why people live in poverty.

Flawed Character (FC)

This hypothesis states that individuals are in full control of their economic status; those who are poor therefore lack motivation and work ethic.

The theoretical foundation of the FC argument is the economic concept of *human capital*. Everyone starts off with a certain set of abilities (*endowments)*. Those abilities are developed with investment. Those who move up the economic ladder are those who made the necessary investments.

There are 3 links for the human capital argument to hold.

1. Human capital is rewarded in the market place.
   There are numerous economic studies that try to estimate the "returns to schooling." In principle, this should be a simple exercise – comparing the wages of those who are less educated to those who are more educated.

In practice, it is fairly challenging because *omitted factors* such as motivation and ability both affect the decision to go to school and future wages. That is, those who are more motivated are probably more likely to go further in school and more likely to earn more later on. But it is perhaps that latent motivation, rather than the schooling, that accounts for some (or all) of the higher wages that we see.

In reality, the returns to schooling appear to be around 8% for each additional year of schooling (Angrist and Kruger, Quarterly Journal of Economics, 1991).

2. Individuals make rational choices.

People need to know their options; many universities conduct outreach campaigns to disadvantaged youth, which suggests that theses options may not be very well known.

People need to be able to choose among them. Obviously, the costs of going to college may be prohibitive, and many families are not fully aware of the financial aid opportunities.

In general, economics is based on rational choice, however.

3. Existence of opportunity

This assumes that anyone – regardless of race, gender, etc. – can move up the economic ladder by making the appropriate investment.

Restricted Opportunity (RO)

This hypothesis states that individuals are poor from circumstances beyond their control.

Some examples of RO include lack of access to good schools and good jobs. This hypothesis argues that not all individuals have equal opportunity, perhaps because of discrimination.

The RO hypothesis need not originate from overt discrimination, however – for example, the failure of some absent fathers to pay child support handicaps the mother's ability to raise the children and secure employment.

Sidenote: Around 85% of custodial parents were mothers. Among those who had child support awards, about three-quarters of custodial parents received at least some child support payments. Many of those parents did not receive the full payment however.

Source: http://www.census.gov/prod/2002pubs/p60-217.pdf

See "Figure 5" from the Census document at the end of these lecture notes.

Big Brother (BB)

This hypothesis states that the government creates bad incentives for individuals to work or have stable families.

Unlike the first hypothesis, poor people are not inherently flawed.

Unlike the second hypothesis, opportunities do exist for poor people to "move up."

The government distorts decision-making through high tax rates, welfare benefits, racial quotas, and other policies.

Welfare benefits, for example, are available only to those are are very poor, and are taken away (taxed away) at nearly a 100% tax rate.

Welfare benefits are mainly (though not exclusively) targeted to single parent households.

See "Table 1" at the end of these lecture notes, taken from Yelowitz (2001).

This comes from: http://gatton.uky.edu/Faculty/yelowitz/Yelowitz-ph.pdf

III. Dimensions of Well Being

Most debates about inequality and poverty focus on *current income*. This has a number of problems, however.

Should we care about income or happiness?

A study by Lane (1993) reports that there is only a weak relationship between economic status and self-reported levels of satisfaction.

In consumer theory in economics, we maximize *utility*, not income. Of course, economic theory also posits that higher income will lead to higher utility (through the non-satiation assumption, or "more is preferred to less").

For the poorest people, additional money did increase the level of happiness.

Wealth

When we measure poverty, we only account for current income, but should we worry as much about someone who had relatively low income but fairly high wealth? Many retired elderly would fit into this scenario. The only way that wealth could enter into current income is through dividend payments, realized capital gains, etc.

Transitory versus permanent income / life cycle dynamics

Some individuals (such as college students) currently have low income, but will almost certainly have much higher income over the course of their lifetime. Similarly, there is an "age-earnings" profile, where earnings usually peak when an individual is in their 40's or 50's, and is usually the lowest when an individual is in their 20's. Younger individuals (or those in school) might be viewed as *temporarily* poor, but are probably not poor over the entire course of their life.

Economic theory suggest that people make decisions based on their *permanent* income – that is, the present discounted value of their lifetime income stream. The *permanent income hypothesis (PIH)* would therefore suggest that when a person's income is low (e.g. when he is in school or retired), that he should borrow (or dissave). When a person's income is high, he should save (or pay off debt) for these anticipated events. Fundamentally, then, the PIH suggests that individuals should *smooth consumption* over time, so consumption expenditure should be less variable than income.

Examples

1. A person might take out a student loan to pay for college (along with room and board), rather than skipping meals and not being able to enjoy fun things.
2. A person might borrow on a credit card if he is laid off from a job, rather than skipping some essentials.
3. A person might take out a mortgage to buy a house sooner than he otherwise would if he had to save up for one on his own.
4. A person might pay off debt when he has a good job, rather than spending the entire paycheck.

Public provisions

Although it is not counted as part of income, the public sector provides a number of goods and services that people consume.

Schools, libraries, parks, roads, and services.

Some nations (not the U.S.) provided universal health care.

IV. Poverty: Drawing a Line

Absolute Approach

Begins with the concept of minimum subsistence – that is, some bundle of goods that is regarded as "essential" to the physical well-being of a family unit. In the most extreme form, it consists of the minimum caloric intake essential to human existence, and perhaps some form of shelter.

World Bank definition: $1 per day per person. Over one billion people in the world were classified as poor in 1998 by this definition.

Once these life-sustaining requirements have been met, there is not much agreement on how many "extras" can or should be included in a bundle of minimum goods and services.

In principle, the list of absolute necessities should change little over time.

Relative Approach

In reality, the absolute approach inevitably takes into account subjective views about what goods are essential.

The relative approach states that a person is poor when his or her income is significantly less than the average income of the population.

For example, one arbitrary measure might define poverty as the low end of the income distribution – such as the lowest 20% of the income distribution.

> This suffers from two big problems. First, some fixed population (in this case, 20%) is *always* regarded as poor. Second, it says nothing about quality of life.

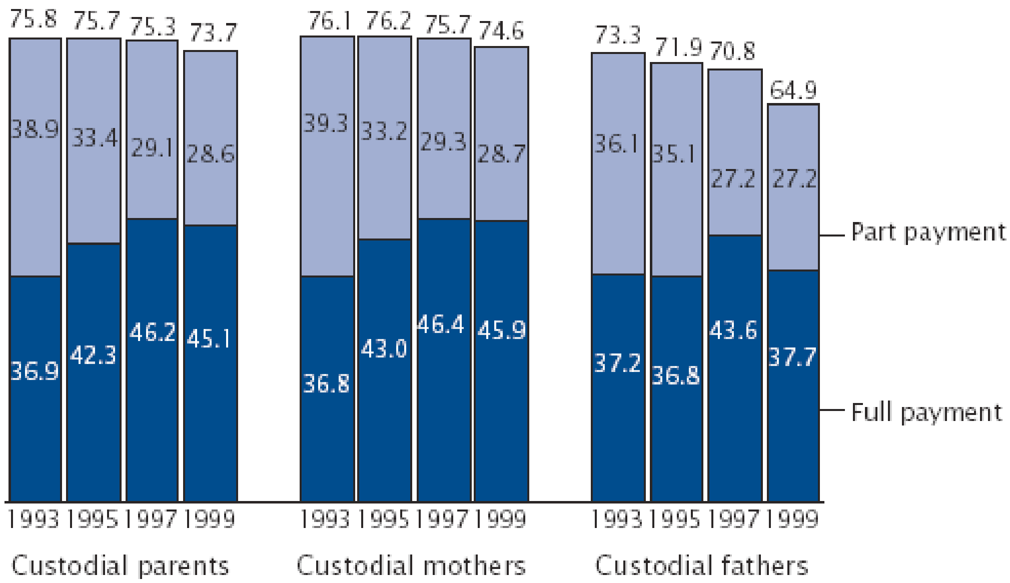
An alternative, knows as the "Fuchs point" in the Schiller book, takes one-half the median income as the poverty level.

> This too is arbitrary, but it does not impose that a fixed portion of the population lives in poverty.
>
> Note that half the median is <u>not</u> the same as the 25th percentile.
>
> Graphical examples of computing the poverty rate with the Fuchs point.

Figure 5.

Custodial Parents Receiving Part or Full Child Support Payments Due: 1993-1999

(Percent)



Source: U.S. Census Bureau, Current Population Survey, April 1994, 1996, 1998, and 2000.

Table 1: Earnings and benefits after four months on job for a mother with two children with day care expenses
1996 -- Philadelphia, Pennsylvania.

Earnings	EITC	AFDC	Food Stamps	Medicaid $3307	Eligible for public housing	Housing subsidy, 2 bedrooms	Social Security Tax	Federal Income Tax	State Income Tax	Work Expenses	Total Income
0	0	5052	2722	Yes	Yes	8136	(0)	(0)	(0)	(0)	19217
2000	800	4892	2410	Yes	Yes	7936	(153)	(0)	(0)	(600)	20592
4000	1600	3292	2530	Yes	Yes	7464	(306)	(0)	(0)	(1200)	20687
5000	2000	2492	2590	Yes	Yes	7224	(383)	(0)	(0)	(1500)	20730
6000	2400	1692	2650	Yes	Yes	6984	(459)	(0)	(0)	(1800)	20774
7000	2800	892	2710	Yes	Yes	6744	(536)	(0)	(0)	(2100)	20817
8000	3200	0	2798	Yes	Yes	6484	(612)	(0)	(0)	(2400)	20776
9000	3556	0	2618	Yes	Yes	6264	(689)	(0)	(0)	(2700)	21356
10000	3556	0	2438	No	Yes	6024	(765)	(0)	(0)	(3000)	18253
15000	2842	0	1538	No	Yes	4824	(1148)	(0)	(420)	(4200)	18436
20000	1789	0	0	No	Yes	3624	(1530)	(0)	(560)	(5200)	18123
22000	1368	0	0	No	Yes	3084	(1683)	(260)	(616)	(5400)	18493
23000	1157	0	0	No	No	0	(1760)	(452)	(644)	(5400)	15901
25000	736	0	0	No	No	0	(1913)	(794)	(700)	(5400)	16929
30000	0	0	0	No	No	0	(2295)	(1628)	(840)	(5400)	19837
50000	0	0	0	No	No	0	(3825)	(5187)	(1400)	(5400)	34188

Notes: In adding the numbers across each row to get total income, negative values are in parentheses. Source: Yelowitz, 2001.