

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). As a 7-year-old poll, however, one wonders whether the answers would be different today.

- 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

Schiller offers 3 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 Flawed Character 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 these 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. This wouldn't be true if there was extensive discrimination.

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>

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 who 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”, taken from Yelowitz (2001), located at <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. See, also, the recent work by Daniel Kahneman & Alan Krueger:

<http://www.krueger.princeton.edu/PDF%20of%20Kahneman%20Krueger%20paper.pdf>

<http://www.princeton.edu/main/news/archive/S15/15/09S18/index.xml>

- 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.

FIGURE: Show budget constraint in 2 period model.

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 vs. Relative

Absolute: 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.

Relative: states that a person is poor when his or her income is significantly less than the average income of the population.