

# Poverty, Inequality and the Welfare State

## Lectures 3 and 4

Le Grand, Propper and Smith (2008): Chp 9

Stiglitz (2000): Chp 14

Connolly and Munro (1999): Chp 14, 15, 16, 17

# Outline

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- Income and wealth defined
- Measuring poverty
- Measuring inequality
- Measuring income mobility
- The market system and social insurance
- The re-distributive role of Government

# Standards of Living: Income and Wealth Defined

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- Income defined: the flow derived from a stock of wealth
- Wealth yields a flow of income
  - Financial wealth
  - Physical assets
  - Human capital
- Measuring Wealth
  - Full money income = money income + non-money income
  - In practice, income is measured by money income only

# Measuring Standards of Living

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- GDP per capita
- **OECD modified equivalence scales**
  - household income, adjusted for household size and age composition
- Numerical example
  - Weights: household head (1); additional member (0.5); child (0.3)
  - Income for household (married couple with 2 children) = £42k
  - What is equivalent standard of living for a single person?
  - What is household income per capita?

# Measuring Poverty

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- Definition of the “poor”?
  - Absolute: standard of living at subsistence level  
eg US\$1 a day (WB)
  - Relative: relative to standards of living in society  
(% of average income)
- UK official definition of poverty
  - Household income below 60% of the **median**
- International measures
  - Official poverty statistics (UK, US) v social exclusion (Europe)

# International Comparisons (Smeeding 2006)

<b>Table 1 Absolute Poverty (%)</b>	
UK	<b>12.4</b>
US	8.7
Germany	7.6
Sweden	7.5
Netherlands	7.2
Canada	6.9
Finland	6.7
Belgium	6.3
Austria	5.2
Germany	8.3

<b>Table 2 Relative Poverty (%)</b>	
US	17.0
Ireland	16.5
Italy	12.7
UK	<b>12.4</b>
Canada	11.4
Germany	8.3
Belgium	8.0
Austria	7.7
Netherlands	7.3
Sweden	6.5
Finland	5.4

# Limitations of Poverty Measures

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- Depth of poverty: how far below the poverty line?
- Is income a good indicator of standards of living?
  - The consumption-leisure trade-off
  - The life-cycle hypothesis
  - Complex nature of poverty
- Alternative indicators of standards of living
  - Expenditure: consumption smoothing
  - Relative deprivation indexes
- Other measures
  - Neighbourhood poverty
  - Capabilities eg UN Human Development Index

# Poverty v Inequality

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- **Poverty:** concerned with a standard of living below which people are poor
- **Inequality:** distribution of resources among individuals and groups
- **Inequality and absolute Poverty**
  - Complete equality but everyone poor
  - Complete inequality and nobody poor
- **Link between inequality and relative Poverty**
  - If society is unequal, it is likely that some people fall below poverty threshold

# Measuring Inequality I

- Concentration of resources

<b>Year</b>	<b>Top 1%</b>	<b>Top 10%</b>	<b>Top 50%</b>
1966	33	69	97
1976	21	50	92
1986	18	50	90
1996	20	52	93
2004	21	53	93

Source: HM Revenue and Customs

# Measuring Inequality II

- The **Lorenz curve**

- Perfect equality of income along the diagonal line
- Income inequality if the Lorenz curve is below the diagonal
- Equality achieved via re-distribution of amount = distance between the Lorenz curve and the diagonal
- **Gini coefficient:** measures this distance ie the higher the value, the more unequal the distribution of income

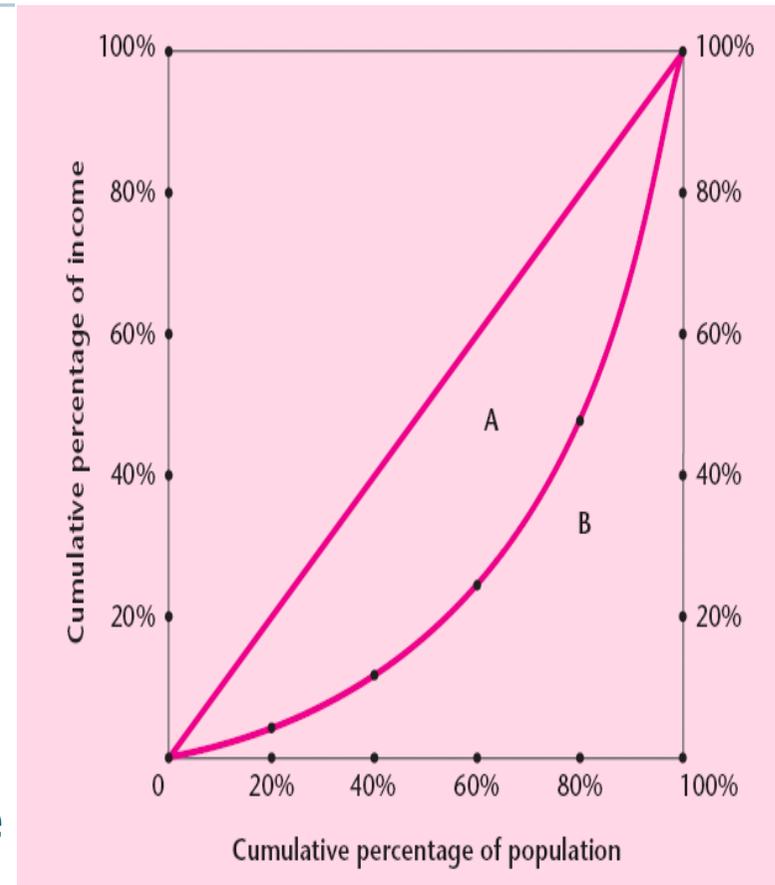


Figure 5.6

# Measuring Income Mobility

- Poverty and Inequality: “snapshot” of living standards at a point in time
- Income mobility: dynamics of incomes over time
  - Individual level
  - Inter-generational eg a transition matrix

Father's income quartile	Son's income quartile			
	Lowest	2 <sup>nd</sup>	3 <sup>rd</sup>	Top
Lowest	0.34	0.30	0.24	0.13
2 <sup>nd</sup>	0.29	0.31	0.25	0.14
3 <sup>rd</sup>	0.30	0.24	0.24	0.21
Top	0.06	0.14	0.27	0.52

Source: UK National Child Development Survey

# Government Intervention in Poverty and Welfare: Equity

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- Promote a fair and equitable distribution of resources
- 1. Minimum level of social insurance
  - A basic minimum standard of income which no one falls below
  - Temporary income relief...UK post-war welfare state
  - Additional support for families
- 2. Social Justice
  - Equality of opportunity
  - Factors beyond a person's control eg different starting points
  - The barriers to equal outcomes involve social factors
  - Measured by income mobility
- 3. Equality of outcomes
  - Goal that income be equally distributed. Attainable?

# Government Intervention in Poverty and Welfare: Efficiency

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- In the absence of equity concerns, govt action is still justified
- Market system is unlikely to lead to a fair distribution of resources
  - Limit supply artificially
  - Market power
  - Discrimination
- The market may fail to provide insurance for those willing to buy it because of **market failures**
  - Social risks
  - Adverse selection
  - Moral hazard
- Primary functions of govt include insurance against disability, unemployment and old age

# Re-distributive Role of Govt Intervention I: Direct Provision

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- Insurance against poverty related circumstances
- Categorical benefits
  - Eligible, regardless of income
  - A form of income replacement
  - Provide minimum standards and reduce inequality, but not targeted
- Asset-based welfare
  - provide people with financial assets v income replacement
  - Why?
  - Consumption smoothing
  - Unexpected spending needs and borrowing ability
  - Funds for investment eg Child Trust Fund

# Re-distributive Role of Govt Intervention II: Regulation

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- Regulation of prices
  - eg National Minimum Wage (1999)
- Distributional consequences
  - $E_F$ : cost borne by shareholders ( $\downarrow$  profits) or consumers ( $\uparrow$  prices); labourers gain
  - Reduce poverty and inequality?
  - Social justice and fair pay
  - Equality and pay caps

# Re-distributive Role of Govt Intervention III: Taxes and Subsidies

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- UK tax system: progressive
- Means-tested benefits
  - targets low income households
  - reduce poverty, but take-up rate: 80%
  - reduce inequality: Gini coefficient
  - Promote social justice? Short-termism
- Means-tested benefits and a culture of dependency?
  - Cultural mechanism: acceptability
  - Economic mechanism: disincentives to work; loss of benefits in-kind; and costs associated with working  
...the **poverty trap**

# Reforming the Benefits System

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- The Traditional Welfare State: criticised
  - Culture of dependency
  - Abuse and fraud
  - Undermines incentives to work and save
- Are the poor feckless or rational economic agents?
- Overcoming disincentive problems: “make work pay”
- UK: eg Working Families Tax Credit (WFTC)
  - Means-tested benefits, conditional on min 16 hours work pw
  - Above threshold level of earnings, amount of credit gradually decreases: 60% rate
  - Applicable to households with children
  - NB positive effect for lone parents

# Summary

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- Standards of living and the distribution of resources
  - Poverty
  - Inequality
  - Income mobility
- Markets and Efficiency
  - Aggregate risks
  - Adverse selection
  - Moral hazard
- Govt policy and Equity
  - Minimum standards
  - Equality of Opportunity
  - Equality of Outcomes
- Reforms of the Welfare State
  - Asset-based welfare
  - National minimum wage
  - In-work benefits eg UK Working Families Tax Credit