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

• 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

• 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

- **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

• 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)

## Table 1  Absolute Poverty (%)

<table>
<thead>
<tr>
<th>Country</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>UK</td>
<td>12.4</td>
</tr>
<tr>
<td>US</td>
<td>8.7</td>
</tr>
<tr>
<td>Germany</td>
<td>7.6</td>
</tr>
<tr>
<td>Sweden</td>
<td>7.5</td>
</tr>
<tr>
<td>Netherlands</td>
<td>7.2</td>
</tr>
<tr>
<td>Canada</td>
<td>6.9</td>
</tr>
<tr>
<td>Finland</td>
<td>6.7</td>
</tr>
<tr>
<td>Belgium</td>
<td>6.3</td>
</tr>
<tr>
<td>Austria</td>
<td>5.2</td>
</tr>
<tr>
<td>Germany</td>
<td>8.3</td>
</tr>
</tbody>
</table>

## Table 2  Relative Poverty (%)

<table>
<thead>
<tr>
<th>Country</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>17.0</td>
</tr>
<tr>
<td>Ireland</td>
<td>16.5</td>
</tr>
<tr>
<td>Italy</td>
<td>12.7</td>
</tr>
<tr>
<td>UK</td>
<td>12.4</td>
</tr>
<tr>
<td>Canada</td>
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<td>6.5</td>
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<tr>
<td>Finland</td>
<td>5.4</td>
</tr>
</tbody>
</table>
Limitations of Poverty Measures

- 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

- 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

<table>
<thead>
<tr>
<th>Year</th>
<th>Top 1%</th>
<th>Top 10%</th>
<th>Top 50%</th>
</tr>
</thead>
<tbody>
<tr>
<td>1966</td>
<td>33</td>
<td>69</td>
<td>97</td>
</tr>
<tr>
<td>1976</td>
<td>21</td>
<td>50</td>
<td>92</td>
</tr>
<tr>
<td>1986</td>
<td>18</td>
<td>50</td>
<td>90</td>
</tr>
<tr>
<td>1996</td>
<td>20</td>
<td>52</td>
<td>93</td>
</tr>
<tr>
<td>2004</td>
<td>21</td>
<td>53</td>
<td>93</td>
</tr>
</tbody>
</table>

Table 3: UK Distribution of Wealth

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

![Lorenz Curve Diagram]

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

<table>
<thead>
<tr>
<th>Father’s income quartile</th>
<th>Son’s income quartile</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Lowest</td>
<td>2&lt;sup&gt;nd&lt;/sup&gt;</td>
<td>3&lt;sup&gt;rd&lt;/sup&gt;</td>
<td>Top</td>
</tr>
<tr>
<td>Lowest</td>
<td>0.34</td>
<td>0.30</td>
<td>0.24</td>
<td>0.13</td>
</tr>
<tr>
<td>2&lt;sup&gt;nd&lt;/sup&gt;</td>
<td>0.29</td>
<td>0.31</td>
<td>0.25</td>
<td>0.14</td>
</tr>
<tr>
<td>3&lt;sup&gt;rd&lt;/sup&gt;</td>
<td>0.30</td>
<td>0.24</td>
<td>0.24</td>
<td>0.21</td>
</tr>
<tr>
<td>Top</td>
<td>0.06</td>
<td>0.14</td>
<td>0.27</td>
<td>0.52</td>
</tr>
</tbody>
</table>

Source: UK National Child Development Survey
Government Intervention in Poverty and Welfare: Equity

• 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

- 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

• 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

• Regulation of prices

• Distributional consequences
  – $E_F$: cost borne by shareholders (↓ profits) or consumers (↑ 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

- 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

- 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

• Standards of living and the distribution of resources
  – Poverty
  – Inequality
  – Income mobility

• Markets and Efficiency
  – Aggregate risks
  – Adverse selection
  – Moral hazard

• Reforms of the Welfare State
  – Asset-based welfare
  – National minimum wage
  – In-work benefits eg UK Working Families Tax Credit

• Govt policy and Equity
  – Minimum standards
  – Equality of Opportunity
  – Equality of Outcomes