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INCOME INEQUALITY AND POVERTY

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ABSTRACT

The first part of this paper argues that income inequality is not a problem in need of remedy. The common practice of interpreting a rise in the gini coefficient measure of inequality as a bad thing violates the Pareto principle and is equivalent to using a social welfare function that puts negative weight on increases in the income of high income individuals. The real distributional problem is not inequality but poverty. The paper considers three sources of poverty and asks what if anything might be done about each of them: unemployment; a low level of earning capacity; and individual choice.

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Is Income Inequality Really a Problem?

The title of this Federal Reserve conference, Income Inequality: Issues and Policy Options, and the discussion during the past two days imply that income inequality is a problem and that there is therefore a need for policies to reduce inequality. I disagree. The real problem on which this meeting should have focused is not inequality but poverty.

The difference is not just semantics. It is about how we should think about the rise in incomes at the upper end of the income distribution.

Imagine the following: as you leave here today, a small magic bird appears and gives each of you $1000. We would all think that that is a good thing. And yet the nation's gini coefficient would rise, indicating a greater inequality. That is the "problem" on which many of the papers and much of the discussion here has concentrated, attempting to assess the extent and change in inequality by comparing the level and trend of the gini coefficient for the United States and other countries. I think it is wrong to consider it a problem.

When professional economists think about economic policies, we generally start with the Pareto principle that a change is good if it makes someone better off without making anyone else worse off. I find it hard to see how one could disagree with such a principle. No doubt that is why it is the widely accepted foundation for the evaluation of economic policies.

A change that increases the incomes of high income individuals without decreasing the incomes of others meets that test: it makes some people better off without making anyone else worse off. I think such a change should be regarded as good even though it increases inequality.

Not everyone will agree with me. Some see inequality as so unlovely that they regard increasing the income of the well to do as a "bad thing" even if their increased income does not come at anyone else's expense. Such an individual, whom I would describe as a "spiteful egalitarian," might try to reconcile this with the Pareto principle by saying, "It makes me worse off to see the rich getting richer. So if a rich man gets $1000, he is better off and I am worse off. I don't have fewer material goods, but I have the extra pain of living in a more unequal world." I reject such arguments and stick to the basic interpretation of the Pareto principle that if the material well-being of some individuals increases with no decrease in the material well-being of others, theat is a good thing even if it implies an increase in measured inequality.

Note that rejecting spiteful egalitarianism does not entail rejecting redistributive policies and tax progressivity. Such policies reflect an assumption that the social marginal utility of income declines as income rises. In contrast, objecting to increasing inequality as measured by the gini coefficient implies that the social marginal utility of high incomes is actually negative, i.e., that something bad has occurred when the well to do become better off.

Recent increases in high incomes

There has no doubt been a relatively greater increase in higher incomes in recent years in the United States and in some other countries. This increase in higher incomes has been the results of several things:

(1) Increases in productivity

There are now more individuals with advanced education and enhanced marketable skills. In addition, market forces are changing in ways that reward these high skills relatively more than they did in the past, thus strengthening the incentive for individuals to acquire these skills and to select occupations in which such skills are rewarded.

(2) Entrepreneurial successes

My impression is that there has been an increase in entrepreneurial activities and that the creation and growth of new businesses has been an important source of the rise in the number of high income individuals.

(3) Increased work by high wage individuals

We all know about investment bankers, lawyers and other highly paid professionals who are now working 70 or more hours a week, twice the weekly hours of a typical employee. Professor Dora Costa, an economic historian at MIT, has recently reported (Costa, 1998) that this observation is part of a more general trend toward longer working hours for higher paid employees, a reversal of the earlier tendency of those with lower wages to work longer hours. The result of this, she notes, has been to increase measured inequality.

(4) A lower cost of capital

Declines in the cost of capital, reflecting an improved fiscal outlook and perhaps a decrease in perceived financial risk as a result of lower inflation, translate into higher stock and bond prices, an additional source of increased wealth for those with higher incomes.

Each of these four sources of higher incomes for those at the upper end of the distribution is a good thing in itself. They add to the income or wealth of those individuals without reducing the incomes and wealth of others.

Note that in rejecting the criticism of inequality per se and in asserting that higher incomes of the well off are a good thing, I am not referring to the functional arguments that some have offered in defense of inequality, i.e., that an unequal distribution of income may contribute to general economic growth and therefore the standard of living of the poor by increasing the national saving rate or because the inequality is a reflection of Schumpeterian innovation that eventually helps most or all individuals in the economy. Nor am I defending the high incomes because the affluent support charitable causes and the creation of products of "high culture." These may be true and may even be convincing to someone whose welfare function excludes the well-being of the wealthy or gives negative weight to their increased well-being. But I am not relying on such arguments because I want to stress that there is nothing wrong with an increase in the well-being of the well-off or with an increase in inequality that results from a rise in higher incomes.

Sources of Poverty and Anti-poverty Policy Options

I turn now to what I believe to be the real problem on which this conference should have focused, the problem of poverty. For this purpose, I am thinking about the incomes of those in the bottom decile or quintile of the income distribution. After discussing the problems of measuring poverty, I will consider three possible sources of poverty -- unemployment; a lack of earnings ability; and individual choice -- and what can be done about them.

Problems of Measuring Poverty

There are of course many problems in measuring the incomes of the lowest income group. As Larry Katz noted in his remarks to this conference, cash income is a misleading indicator and a broader measure that includes in-kind benefits like health care and housing implies much less poverty. There is also a problem in classifying someone as poor if his or her

income is only temporarily low.

More generally, sociologists who have actually observed the poor directly and spoken with them about their living conditions (a research method that economists use too little) have been puzzled by how the poor could live on so little income. Those who gained the confidence of the poverty groups that they studied have come back with a simple answer: the underground economy. The true incomes of many of those with very low measured incomes are actually higher than the data indicate because the individuals earn income that they do not report since doing so might reduce their eligibility for cash and in-kind transfers.

This is a major problem for studies of the incomes of the poor. I have often felt that careful studies of income distribution are most reliable when they focus on the wage distribution in the middle of the income distribution, an unfortunate fact since the most interesting questions are about the very poor and the very rich for whom data are simply not very good.

A separate issue that plagues attempts to measure trends in poverty and in income levels more generally is the difficulty of measuring changes in the cost of living. A growing body of research implies that the consumer price index and related official measures overstate the rise in the true cost of living and therefore understate the rise in real personal incomes; see Boskin et. al. (1996) for a discussion of these issues. Even if the bias in the CPI is as little as one percent a year, the cumulative effect over two decades is to understate the growth of real incomes by more than twenty percent.

All of these measurement issues should make us cautious about attempting to assess changes in the extent of poverty over time. Nevertheless, there is no doubt that poverty today is a real and serious problem in the United States and other countries. I turn therefore to consider three sources of poverty and the policies that might be directed to counter these sources of

poverty.

(1) Unemployment and poverty

Since this conference is sponsored by the Federal Reserve, the role of unemployment as a possible cause of poverty is particularly relevant. There exists a small but serious amount of very long term unemployment in the United States that creates poverty and hardship. It is a serious problem for our economy. The extent of it goes beyond the measured amount of long-term unemployment since most individuals who have been out of work for considerable periods of time in the United States are classified as "not in the labor force" rather than unemployed. But although this long-term nonemployment is a problem and a source of poverty, it is not a cyclical problem that is amenable to expansionary monetary policy. I return below to some of the reasons that individuals remain out of the labor force.

This is very different from the unemployment of the depression years when a large fraction of the labor force were unemployed and out of work for a year or longer. The current long-term nonemployment is also very different from the cyclical unemployment that we see now in the United States. Most cyclical unemployment spells are short, ending in less than ten weeks. During such spells of unemployment the decline in consumption is very small. Unemployment insurance replaces more than half of the lost net income of those who receive benefits and the earnings of second earners in the household of the unemployed help to stabilize total household income. While the unemployed may not have access to formal lines of credit, they are often able to defer payments during part or all of their unemployment spells.

The situation is of course different in Europe where unemployment rates tend to rise during recessions but not to come back down again in the recovery. Cyclical unemployment becomes long term unemployment because of the adverse incentives in European system of

unemployment benefits and welfare payments.

Reform of the American unemployment system in the 1980s led to a decline in the rate of unemployment. One important aspect of these reforms was subjecting unemployment benefits to the personal income tax, a reform that obviously did not affect the poor (who do not pay income tax) but which reduced the very high replacement rates that previously made it possible for some individuals in higher income households to have more net income by being unemployed than by working.

(2) Lack of Earning Ability

The most commonly recognized reason for poverty in the United States is the inability to earn more than a very low wage. This low earnings ability is often attributed to inadequate schooling or training.

It is clear that a low level of schooling or poor quality schooling can limit an individual's earning ability and that the obvious remedy is more schooling or better schooling. There is an important discussion now in the United States about how to achieve this improvement. A key conclusion that appears to be emerging from the research on this subject is that decentralization and competition is the key to improving education. Larry Katz commented earlier in the conference that the research that he and Claudia Golden have done shows that the historic spread of high school education and vocational education in the United States reflected decisions of local governments rather than the actions of the states or federal government. Research by Caroline Hoxby (1994) and others shows that the quality of local public education today is improved (as measured by graduation rates, continued education, post-school wages, etc) in areas where there is more competition due to a larger number of school districts or a greater availability of nonpublic (typically parochial) education. This emphasis on the importance of

competition has increased interest in the potential use of vouchers to increase individual choice.

A second reason for low earnings ability is inadequate training. Experience suggests that the best training is on the job training. The German system of formalized apprenticeships appears to allow Germany to escape the high youth unemployment rates that plague much of Europe and may also reduce poverty in later years. In the United States, in contrast, the minimum wage legislation limits the ability of individuals with low skills, low education and low ability to obtain on the job training. Although someone who comes to a job with good ability and skills can both earn at least the minimum wage and also obtain additional skills through on the job training, an employer cannot afford to pay the minimum wage and provide training to those with the lowest skills.

The evidence on government sponsored training programs for the middle-aged unemployed is very discouraging. For women, participation in training programs raises employment and wages by more than the cost of the training but the impact on employment and poverty for the group of trainees is very small. For men, the results are even worse: the gains from training are less than the costs.

The problem of low human capital as a source of poverty is not just a matter of schooling and training but is also one of low cognitive ability. As I read the evidence, while variations in cognitive ability (IQ) in the neighborhood of the mean do not have much impact on wage rates, individuals with very low levels of cognitive ability (IQ levels below 80) have a very hard time earning a decent wage rate. This is not a fashionable view. Americans like to think that all men and women are quite literally created equal and that education can solve the problem of low human capital and therefore of low earnings. Unfortunately, however, very low cognitive ability is likely to be a serious cause of poverty that cannot be remedied by education and training.

Finally, there are those for whom low earnings ability reflects pathologically dysfunctional life styles – drug abuse, alcoholism, and mentally illness. As Assar Lindbeck said earlier at this meeting, the policies needed to deal with these specific problems must be particular to each problem.

(3) The Role of Individual Choice

Not all poverty can be attributed to involuntary unemployment or to the lack of earnings ability. Individual choice, rational or irrational, can lead to poverty.

More specifically, those individuals who choose to be in poverty may be making rational choices , i.e., individuals may choose leisure (not working or working very little) to cash income even though the result is to leave them in a poverty condition which they could otherwise avoid. This may be a source of increasing poverty. Over time, the standard of living that is possible without working has increased for some segments of the population as a result of the rise in the real value of cash and in-kind welfare benefits. Often the real value of these welfare benefits has increased more rapidly than the real value of wages available to low skilled workers, increasing the likelihood that the income effect of such benefits would exceed the effect of rising wages on the attractiveness of work. This is reinforced to the extent that transfer rules reduce the incentive to work. Reducing poverty from this source requires reexamining the structure of welfare programs.

Not all individual choice is properly described as rational and some individuals may choose poverty in error, i.e., they may think that they are making rational (utility maximizing) decisions but their facts are wrong. Some of those individuals may think that they will not like work (or the combination of work and the money that it brings) as much as they currently like staying at home but would discover the opposite if they go to work. Moreover, these individuals

may not recognize that they will advance in their jobs, shifting over time to more appealing work or at least to higher incomes. A policy of "tough love" that forces such individuals to enter the world of work for an extended period of time may be the best type of welfare reform for overcoming this problem.

Monetary Policy

Because this is a Federal Reserve conference, it is appropriate to conclude this discussion with some comments on the potential contribution of monetary policy to the reduction of poverty.

The paper by Romer and Romer (1998) presented at this conference makes the two correct and important points on this issue. First, although expansionary monetary policy can help the poor in the short run by reducing unemployment and raising the wages of the poor, these are temporary and not permanent gains. Second, these temporary gains from expansion come with the cost of a permanent increase in inflation that can permanently hurts those in poverty. It would take a very myopic calculation to conclude that the short run benefits outweigh the long-run costs.

What about moderate inflation? The Romers' analysis and other earlier work present no evidence that a rise in inflation from say 2 percent to 5 percent would hurt the poor. But such a rise in inflation would reduce overall real incomes, thorough the interaction of tax rules and inflation even if in no other way (Feldstein, 1997). Anything that lowers the general standard of living will not be politically tolerated in our democratic system. An increase in inflation will therefore lead to policies aimed at reducing inflation, policies that almost certainly produce rising unemployment and possibly a full recession. A recession would hurt the poor by more than they might gain from temporary expansionary policies.

Poverty presents a different challenge for the central banks of Europe. In Europe, the fear of poverty has led over time to an expansion of redistributive policies that have generated higher and higher levels of unemployment. The high unemployment reflects not only the direct effect of these redistributive policies on the target population but also the indirect effect of the rising level of taxes to finance these benefits that must be imposed on those who remain at work. High unemployment always produces pressures for expansionary monetary policy. Although such pressures have been held in check recently by the low-inflation targets imposed by the Maastricht treaty on countries seeking to join the Economic and Monetary Union, that phase of European history is now complete. The new European Central Bank will undoubtedly face misguided pressures to try to reduce structural unemployment by expansionary monetary policy. Succumbing to such pressures would only lead to higher inflation. A failure to deal with the more basic problem of the mutually reinforcing rise in both unemployment and taxes could be Europe's most serious economic problem in the 21st century.

The final conclusion for central banks should be clear: poverty is a serious problem in all of our economies. Better non-monetary policies may help to reduce poverty and alleviate its long-term intergenerational consequences. But the problems of poverty cannot be solved by monetary policy.

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