

Economics 404W

lecture 20

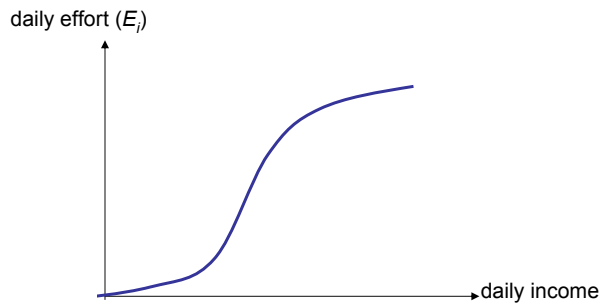
Professor Tybout
March 28, 2006

Note: Next writing assignment to be posted tomorrow

Inequality, poverty and economic performance

- Banerjee and Newman
 - Need collateral to get a loan and become an entrepreneur.
 - Those who don't become entrepreneurs become employees or work in subsistence.
 - The higher the wage rate, the less profitable businesses are, and more difficult it is to qualify for a loan.
- Implications of model
 - inequality is self-perpetuating
 - Equilibria with high inequality are inefficient.

Poverty, nutrition and labor markets



- At minimal income levels, people are just able to support their “resting metabolism”
- As income continues to grow, ability to work improves.
- At some income level, the effects of income on ability to work become insignificant.
- Similar effects result from the relationship between health care and income.

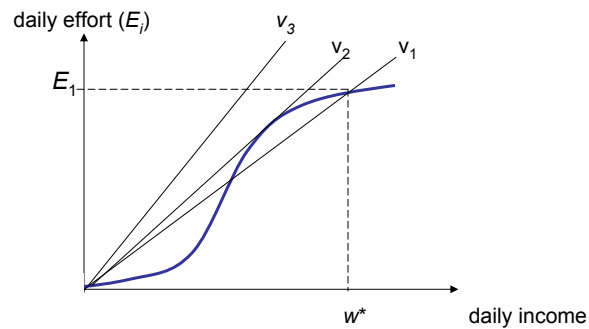
Nutrition and labor markets

We've seen that when individual effort cannot be monitored, employers may set “efficiency wages” to maximize effort per dollar spent on labor. Labor markets may not clear.

Now consider a labor market in which it is possible to monitor individual output

Example: farm workers are paid according to number of bushels harvested.

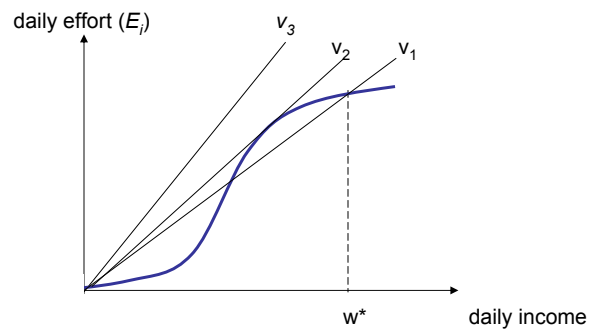
Nutrition and labor markets



v is the piece rate (payment per unit produced). Note that $v_1 > v_2 > v_3$.

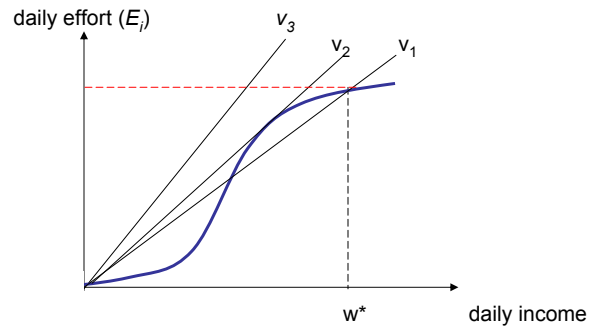
Given v , the effort level of income-maximizing workers is implied. The case of v_1 is depicted above.)

Nutrition and effort



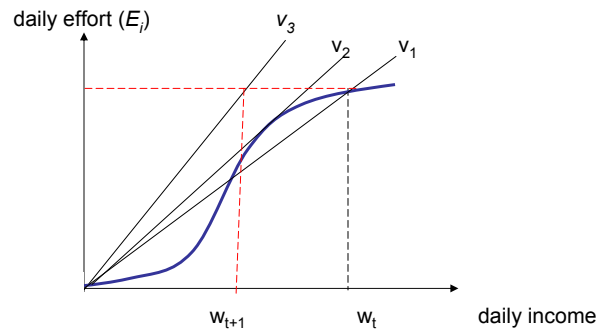
At any rate below v_2 (v_3 , for example), it is not possible to work.

Nutrition and effort



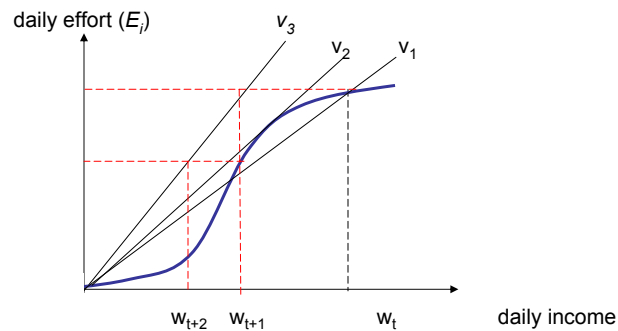
Suppose a worker begins with income w^* at piece rate v_1 , but the piece rate falls to v_3

Nutrition and effort



The next period, her income is w_{t+1} .

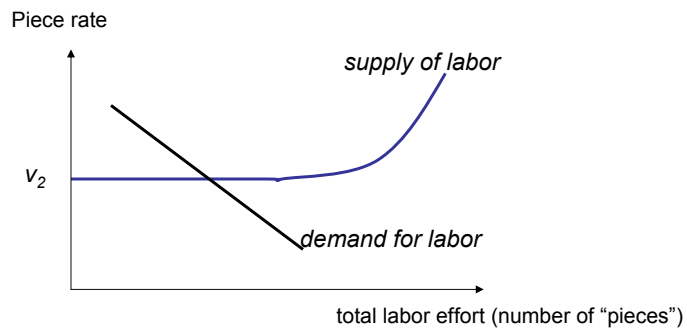
Nutrition and effort



And the period after that, her income is w_{t+2} .

Eventually, income reaches 0.

Poverty and labor markets

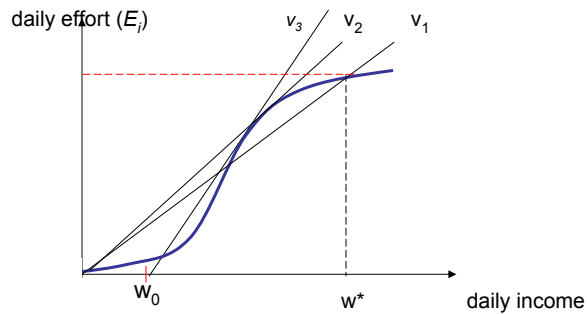


The labor supply schedule can be obtained by aggregating over individuals.

When demand is limited, some fraction of the work force remains unemployed.

Poverty breeds both low productivity and inequality.

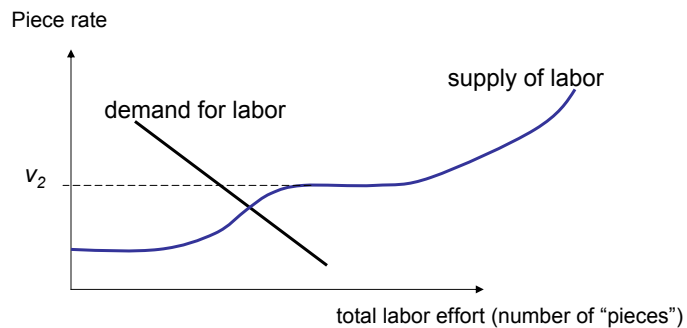
Poverty and labor markets



Existing poverty is likely to be exacerbated. Suppose some people have access to outside income, w_0 . (Family transfers, rent from a spare room, etc.)

These people will be able to work at a lower piece rate (v_3).

Poverty and labor markets

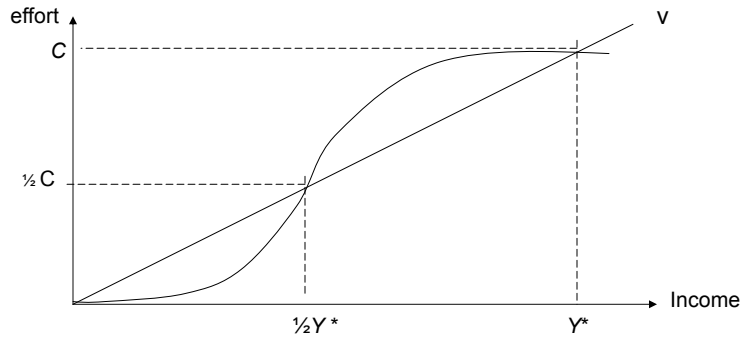


With different people enjoying different levels of outside income, the labor supply schedule might look something like that above.

Those with outside income get the limited jobs; others who are worse off may not be employed. So existing inequality is exacerbated.

Poverty and labor markets

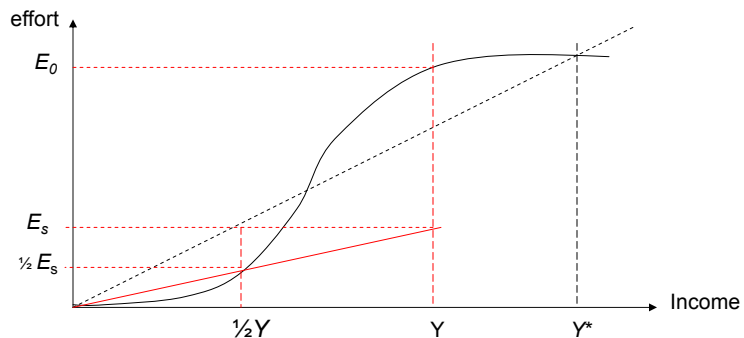
Poverty can also exacerbate inequality when families allocate their income among members.



Consider a household with income Y^* and twin brothers.

They can generate the same amount of effort, regardless of whether one brother consumes everything and supplies all effort, or they share effort and consumption equally.

Poverty and labor markets



But if household income is less than Y^* , say Y , the brothers generate more effort if one of them does all the producing and consuming (E_0) than if they share the income equally (E_s).

Poverty and labor markets

- Who gets rationed? Women and children, probably, although the evidence is a bit murky because dietary needs differ across household members.
 - Rationing may mean infanticide or higher mortality rates among girls due to lack of medical attention or nutrition. (Sex ratios in some countries, e.g., India, UAR, Saudi Arabia, French Guiana, Chad, China, and Cote d'Ivoire back this up.)
 - Children with three siblings are over 50 percent more likely to attend secondary school when all their siblings are sisters than when all are brothers. (Sisters are easier to out-compete for resources.)

Poverty and labor markets

- Widows get rationed

Death rates for married women and widows in Rural Bangladesh

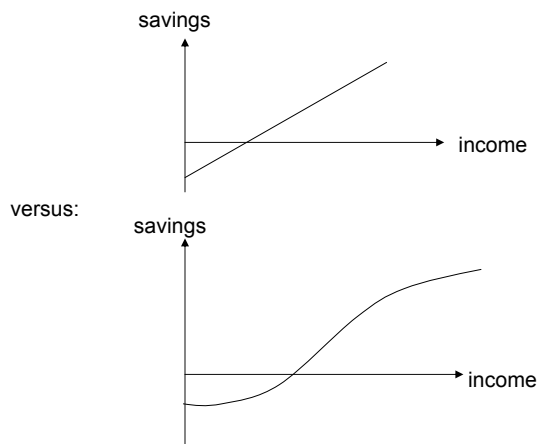
	All ages	49-54	60-64	65-69	70-79	80+
<i>Currently married women</i>	1.87	0.89	3.10	3.81	9.43	9.38
<i>All widows</i>	5.29	1.36	3.83	5.56	9.99	17.50
<i>Widows heading households</i>	3.75	1.68	2.42	5.20	8.63	15.04
<i>Widows in households headed by sons</i>	5.37	1.15	3.86	5.15	9.88	17.66
<i>Widows not in households headed by self or sons</i>	7.59	1.63	5.84	8.27	11.67	18.52

Source: Ray (1998), who cites Rhaman, Foster and Mencken (1992) and Chen and Dreze (1992).

Poverty, inequality and savings

- We've already observed that countries with very low incomes save little.
- The way that income is distributed across households affects the savings rate too.
- *Marginal* propensities are what matter.

Poverty, inequality and savings



Poverty, inequality and savings

- Savings may rise or fall with reductions in income inequality, depending upon initial distribution
- Indirect evidence on the effects of inequality comes from the relationship between inequality levels and growth.

$$\hat{Y}_i = 6.22 - 0.38 * GDP60 + 2.66 * PRIM60 - 3.47 * GINI60 - 5.23 * LANDGINI$$

(4.69) (3.25) (2.66) (1.82) (4.38)

\hat{Y}_i = Per capita income growth, country i , 1965-1980

$GDP60_i$ = initial income per capita

$Prim60_i$ = Primary school enrollment, 1960

$Gini60_i$ = Income inequality, 1960

$LandGini_i$ = Initial land inequality, 1960

Source: Alesina and Rodrik, *QJE* (1994)

Policies for reducing income inequality

- World Development Report argues that institutional/political reform can be key.
- Reforms should focus on equalizing *opportunities* rather than equalizing incomes or wealth.
 - health care (especially pre-natal and infant care, vaccinations, sanitation)
 - public schooling (less spending on higher ed, more on primary, reach the rural areas),
 - infrastructure in poor regions.
- Policies that simply take income or land from rich and give to poor weaken incentives to be productive, innovative and/or to invest.