Public Finance II.

Lecture IX - **Poverty and Inequality**

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Office Hours (Room 5C.30)
Tue 10:00 – 10:45
Thu 12:30 – 13:15

Readings:

- Gruber, J. (2005). Public finance and public policy. Macmillan.
- Congdon, W. J., Kling, J. R., & Mullainathan, S. (2011). Policy and choice: Public finance through the lens of behavioral economics. Brookings Institution Press.

Poverty and Inequality

- Roughly one in seven Americans, more than 43 million people, lived in poverty in 2009. In the United States, poverty is defined as having a low level of market income in absolute terms—that is, as living below the poverty line. For a family of four, for example, that meant a total family income of less than $21,756.

- Incomes at that low level both reflect and create undesirable conditions, not only for individuals who suffer directly the hardships associated with poverty but also for societies and economies that allow such conditions to persist.

- As a result, economic policy often seeks to address the issue of poverty. Social and transfer policies work both to alleviate hardship and to provide individuals and families with the tools and opportunities necessary to escape poverty.

- The rate and depth of poverty in the United States is all the more striking for the way that it compares with the vast wealth of Americans at the other end of the income scale. In 2009, households at the 90th percentile of the income distribution earned more than 11 times as much as households at the 10th percentile.

- Moreover, over the last thirty years the gap between rich and poor has widened to levels not seen since before the Great Depression. The fraction of total income accruing to the richest 10 percent has been more than 45 percent in recent years, up from roughly one-third of income thirty years ago.

vs. Efficiency

- Questions about poverty and inequality are tricky ones for economic analysis, because often the underlying issues are normative. They involve not just efficiency but also equality, and economics alone cannot answer questions about what is just and equitable.
- That said, public finance provides an intellectual framework for tackling those questions, even when it cannot ultimately provide the answers. It provides a way to think about the problems, to measure the conditions, to work through the implications of various assumptions, to delineate the trade-offs that policy must negotiate, and to gauge the relationship of policy design to policy objectives.
- The issues of social welfare, poverty, and inequality thus differ in character from issues related to market failure, such as asymmetries of information or externalities. Whereas with market failures unregulated outcomes were clearly inefficient, poverty and inequality can exist in efficient economies—they may simply be undesirable in some sense.

Preferences vs. Inequality and Poverty

- Two findings from behavioral economics about the shape of preferences are of particular importance to understanding the social welfare consequences of inequality.
- The first is that individuals exhibit behavior consistent with holding preferences over the welfare of others, both in absolute and relative terms.
- Behavioral economics finds evidence, in various forms of other-regarding preferences, that individuals appear to be only imperfectly self-interested. That is, people seem to care about the absolute well-being of others. There is evidence for behaviors consistent with forms of other-regarding preferences from altruism to envy.
- The second is that individuals appear to hold preferences over the process that generates economic outcomes such as the income distribution.
- In particular, individuals exhibit preferences for fairness. As a result, redistributive policies may be justified to foster fairness or to counter perceived unfairness in market outcomes.
- If individuals care about fairness and process, then the social welfare costs of poverty may be larger to the extent that poverty is due to bad luck or circumstance or smaller to the extent poverty is due to bad behavior or decisions. The underlying concern is about unearned poverty. As a result, understanding the causes of poverty has significance for understanding the social welfare impact of poverty.

Trade-Offs in Transfer Policy

- Setting the level and form of transfer policy to correct a given assessment of the problems posed by poverty and inequality requires judgments about policy trade-offs. Transfer and redistribution policies, perhaps more than any other policies in public finance, are ultimately dependent on judgment calls by society and policymakers.

- Making those calls involves consideration of trade-offs across alternative policy states—for example, how much to trade off the protections of redistribution against the disincentives to work that they create. It also involves welfare trade-offs across individuals—judging whether on net social welfare is improved by transferring income from one group or individual to another.

- The traditional model incorporates those trade-offs, and while it cannot resolve them, it comes to a standard set of conclusions regarding their terms. The main trade-off across policies in this model is broadly captured as being between equity and efficiency.

- While policies that improve equity can in principle improve outcomes, in practice they may come at some cost to economic efficiency as individuals change their behavior in response. The specific manifestation that is of primary concern for the narrow purposes of transfer policy is the efficiency cost due to the moral hazard that such programs can create and its effects on labor supply in particular.

- A related set of trade-offs is due to the fact that policymakers typically cannot observe the characteristics by which they would like to identify recipients of benefits. Finally, redistribution motivated by improvements in social welfare due to moving income or resources across people necessarily reflects judgments about relative utilities.

Moral Hazard and Behavioral Tendencies

- Perhaps the key dimension to the efficiency costs associated with transfer policies is the moral hazard that they may create in recipients. By insulating recipients from the full consequences of adverse economic events or unproductive activities, the incentives that those recipients have to protect themselves against those events or to engage in economically productive activities are diminished.

- Of particular interest for income support policies is the moral hazard created with respect to work incentives. By cushioning the blow of low labor income, such programs can reduce incentives to seek and take employment. That comes at a cost to economic efficiency.

- A behavioral approach to the problem of moral hazard created by redistribution emphasizes the coincident forces of behavioral tendencies for covered individuals, in particular, how bounded self-control can reinforce—or supplant—moral hazard.

- Individuals who fail to seek work when they receive benefits may intend to do so but fail to follow through; in that case, what appears to be a diminished incentive to work may in fact be the result of procrastination. Furthermore, benefits may exacerbate the tendency to procrastinate; there is some evidence that welfare programs might have such an effect.

Work incentives

- Why are there time limits to unemployment benefits?
- Finally, even when income support policy successfully delivers benefits to targeted individuals and structures benefits so that recipients can use them to achieve desired outcomes, it also must address the special challenges associated with providing relief to the needy while preserving the incentives for those individuals to provide for themselves when possible.
- Although the primary objectives of income support and antipoverty policies are to ameliorate the particular conditions that they target—such as hunger, for example, or lack of adequate housing—most programs also have a common secondary goal of discouraging continued dependence on program benefits and encouraging self-support and employment.
- The challenge for policy is that those twin objectives are frequently and often inescapably at odds. The provision of means-tested benefits often creates a form of moral hazard, whereby the very benefits that forestall deprivation in poverty, once received, make the conditions of poverty less aversive and diminish the incentives to work and earn income.
- A particular concern in many instances is that individuals may intentionally reduce their labor supply in order to maximize the value of their benefits or to maintain or establish eligibility for benefits.
- The standard assumptions about individual preferences and decisionmaking processes lead to relatively straightforward conclusions about labor supply responses in the presence of income support policies—namely, that labor is a source of disutility, leisure is a source of positive utility, and that income from either earned or unearned sources supports consumption.
- The prescriptions that flow from this approach for policy design then depend on the way that benefits interact with labor income. When benefits are available in the absence of earned income or in addition to earned income, policy in general has to trade off the generosity of benefits against the fact that they will tend to reduce labor supply. Reducing benefits as labor income increases tends to discourage work; on the other hand, designing benefits to supplement labor income can encourage work.

Targeting Recipients

- One way in which policy seeks to minimize the efficiency costs of redistribution is by targeting specific populations to receive transfers. That is difficult even in standard models, because there is a presumed information asymmetry between policymakers and individuals with respect to knowledge about who is truly needy.

- As a result, policymakers employ specific targeting methods, such as tagging based on observable characteristics, or ordeal targeting. Because of the imprecision of such methods, they can lead to errors of either commission or omission—that is, they can lead to benefits being claimed by individuals for whom they are not intended, and they can lead to intended individuals failing to receive benefits. Either comes at a cost to program efficiency.

- The goals of targeting can thus create a set of trade-offs that policy has to resolve. While more generous benefits can come at a cost to efficiency, attempts to target precisely may leave qualified individuals without benefits. Efficient screening depends crucially on having an accurate model of how individuals will behave in response to such measures.

- To the extent that individuals respond to targeting measures in imperfect ways, the features of the trade-off may differ from those under standard assumptions. Of particular concern is the possibility that behavioral tendencies interact with screening mechanisms in ways that undermine their efficiency. For example, when individuals put off filling out benefit applications because they tend to procrastinate or because doing so is a hassle, screening may be ineffective.

- Worse, the screen may actually work in the wrong direction. The hassle costs associated with complex program rules or application procedures may be a relatively more serious barrier for the sort of low-income populations that are the ostensible targets of the policy.

Take-Up and Targeting

- With few exceptions, income support programs target specific populations defined by particular characteristics, circumstances, or means. Programs target an array of groups, often defined by age, disability or health status, family composition, or economic means. In order to restrict the benefits of any given program to qualifying individuals, it is necessary to screen prospective recipients to determine whether they meet the eligibility criteria.

- In practice, that determination often is made by requiring that individuals actively apply for benefits and demonstrate their eligibility. As a result, the effectiveness of income support programs in delivering benefits to targeted individuals is a joint function of who is targeted by the policy, which is defined by eligibility rules, and who takes them up, which is determined by individual behavior.

- Given the elective nature of participation in such programs, not all eligible individuals apply for or take up benefits. And as an empirical matter, the take-up rate—the fraction of eligible individuals who actually receive benefits—of most income support programs is far from perfect.

- The take-up rate is a result of choices made by potential beneficiaries is clearest in the case of programs that pay benefits to all individuals who apply for assistance and who meet eligibility criteria. Still, estimates suggest that even in such case, not all beneficiaries apply. Low participation rates mean that the program is not delivering benefits to some eligible individuals.

- The standard model of the take-up decision treats the choice of whether or not to claim benefits as a straightforward cost-benefit problem. Presumptively eligible individuals weigh the value of the stream of benefits that they could expect to receive as program participants against the costs of applying for and collecting those benefits.

- The costs of program participation take at least two forms: transactions costs (the direct costs associated with claiming and keeping benefits) and stigma costs (the subjective sources of disutility that are associated with receiving benefits). In this model, policies fail to reach the intended recipients if the costs that they impose are large relative to the benefits that they deliver..

Take-Up and Targeting

- While in the standard model low take-up can complement efficient screening because individuals to whom benefits are more valuable are more likely to take them up, that is not necessarily the case in a behavioral model. If, for instance, the neediest individuals have less access to information on programs or are more discouraged by the hassle costs of applying for benefits, then imperfect take-up could be consistent with self-selection into programs working in a way that actually undermines efficient targeting

- A behavioral view of take-up suggests a number of implications for policy design. One is that making it easier for individuals to qualify for and perceive the terms of benefits may have high returns in terms of increased take-up rates.

- Simplifying the application process—requiring fewer forms, using automatic or default enrollment, and so on—could have large effects on take-up, as could making benefits easier to understand—for example, by offering matches instead of credits. Note, however, that different approaches may have different implications for targeting.

- Defaults might bring in a different mix of individuals, in terms of program-relevant characteristics, than, say, simplifying forms, which in turn might have effects that differ from those that result from simplifying benefit schedules.

- A slightly deeper implication is that the complex eligibility that criteria programs set in order to target benefits precisely may come at greater costs than traditional economic analysis suggests. That is, many times qualification procedures or benefit schedules are complex not because policymakers have failed to attend to the costs of multiplying complexity but because they want to have a sophisticated targeting technique. Simplification in such programs would then tend to come at some cost to the ability to target benefits.

- The key behavioral insight is that when individuals are imperfect decisionmakers, marginal reductions in complexity can lead to a marginal deterioration in the ability to screen out ineligible applicants that may generate first-order improvements in take-up rates among those who are eligible a slightly more subtle interpretation of the behavioral lesson for program design is that it is not necessarily program complexity itself that comes at the cost of participation or screening efficiency, but the complexity of the program as experienced by eligible individuals. The complexity of underlying program parameters such as eligibility criteria affects the take-up decision only to the extent that individuals are required to deal with it directly. Policy might, therefore, retain complex eligibility rules but shift the burden of applying those rules from the applicant to the government.

Benefits and Outcomes

- Another fundamental design challenge for programs that provide assistance directly to recipients is to structure benefits to promote the types of outcomes intended. While take-up of programs is necessary to achieve program goals, it is not in general sufficient. The ultimate goal of soccial programs might be thought of as reducing hunger or food insecurity, and thus, these programs might be judged by whether and to what extent they alleviate any of a variety of hardships associated with material deprivation.

- However, delivering benefits is not identical to producing outcomes. For transfer policy to be successful, it must look beyond whether it can get benefits to those in need in order to determine whether those benefits achieve program goals. A behavioral approach can help in making that evaluation because many aspects of program effectiveness are determined by how recipients respond to and make use of benefits. For example, the extent to which benefits lead to reductions in hunger and food insecurity will be a joint product of the form and level of the benefit, on one hand, and the decisionmaking process by which recipients decide how to spend and consume, on the other.

- There is some evidence that designating benefits in a particular way may lead to a labeling effect, whereby recipients tend to dispose of benefits in the ways suggested by their labels instead of treating benefits as fungible with other sources of income. For example, there is an evidence that food stamps might encourage food consumption more than cash trasnfers do. May the food stamps instead of cash be a good idea after all?

Summary

- **Social welfare.** For the purposes of public finance, the consequences of poverty and inequality typically are captured through some measure of social welfare. The standard economics of poverty and inequality shows how those conditions can lead to lower social welfare than under alternative distributions of income. A behavioral approach modifies our understanding of both the causes and consequences of poverty, with implications for the social welfare costs of poverty. It also identifies new ways in which inequality might translate into welfare loss.

- **Moral hazard.** Policies that reduce poverty may also have unintended side effects. Perhaps the primary trade-off that policy responses to poverty and inequality must weigh is that between the benefit of addressing those conditions and the cost due to the moral hazard that such policies can create.

- **Targeting.** The other key policy trade-off in addressing poverty and inequality derives from the general inability of policymakers to distinguish those who require assistance from those who do not. As a result, policy responses often have to trade off two types of errors in targeting, false positives and false negatives.

- **Program design.** Public finance derives a set of principles for designing efficient and effective programs to address poverty and inequality. Such programs seek to deliver benefits to targeted individuals with a minimum of error, to provide benefits in such a way that they translate most efficiently into the desired outcomes, and to structure benefits in order to minimize distortions to incentives, especially work incentives.