

Comps Review Outline: Economics Part 2—The Economics of Poverty

I. The Big Picture: Does aid matter? Does it work? (Sachs vs. Easterly)

A. Jeffrey Sachs (Columbia) *The End of Poverty* (2005) –We need more aid. There are proven solutions to poverty, and they must be scaled up. We will achieve economies of scale within aid.

VS.

B. William Easterly (NYU) *White Man's Burden* (2006) –Well, it's kind of complicated. Aid is prone to failure, and the debate has been highly politicized. Things have to pay attention to local situations and to how our models of economic growth are actually supposed to work.

a. Sach's rebuttal: You're failing to think big. This opportunity is slipping away.

C. Special note: Sach's was one of the "architects" of shock therapy for the former Soviet Union based on the idea of spontaneous order (Friedrich Hayek, Austrian school).

II. Welfare Economics: uses the techniques of microeconomics to determine both allocative efficiency within an economy and associated income distributions.

A. Major concepts

1. social indifference curves—points of substitution with equal (indifferent) benefits to society
2. cost-benefit analysis (CBA)—an applied technique that expresses all social welfare in monetary terms. Very common in policy analysis.

B. Key Economists

1. Vilfredo Pareto (Lausanne) (1848-1923)—Italian micro-economist concerned with documenting income distribution.

a. Pareto Efficiency (or Pareto Optimality): a point at which no further substitutions can be made that do not make at least one party worse off than before. This is the most "maximized" function within a system.

2. John Rawls (Harvard) *A Theory of Justice* (1971)—American political economist concerned with income and fairness

a. Min-Max Criterion—a measure of social welfare that only examines what society's poorest members have. "No economic activity will increase social welfare unless it improves the condition of the society member that is the worst off."

b. Veil of Ignorance—you do not choose which "role" you have in a situation so each role must be evaluated for the fairness of a situation

3. Amartya Sen (Harvard) *Poverty and Famines* (1981), *Development as Freedom* (1999)

a. capabilities approach—it's not what people have, but what they're capable of getting access to

i. influenced UNDP's Human Development Index (HDI)

ii. and DFID's sustainable livelihoods approach

b. entitlements—the "rights" people have of access

c. famine is socially constructed and not merely the result of crop failure

d. famines don't happen in democracies

III. A Key Economist that doesn't fit into "schools"

A. Macrur Olson (Maryland) *The Logic of Collective Action* (1965)

1. Groups will provide themselves with private goods, not public goods
2. It's easier to ensure cooperation in small groups
3. The majority may tyrannize the minority
4. roving bandits vs. stationary bandits

IV. New Institutional Economics (NIE)

A. Key Thinkers

1. Ronald Coase (Chicago)—British economist
 - a. *The Theory of the Firm* (1937)—firms exist (instead of a world of individual contracting) due to transaction costs
 - b. *The Problem of Social Costs* (1960)—due to transaction costs, property rights and initial endowments make a difference in outcomes; property rights might be able to overcome externalities
 - i. Coase's Theorem (Stigler names it such)—if there are no transaction costs, the most efficient solution will occur regardless of initial endowments or legal right
2. Oliver Williamson (UCLA) *Economic Institutions of Capitalism: Firms, Markets, and Relational Contracting* (1985)
 - a. due to transaction costs, much contracting will become based on specific relationships and will not happen in spot markets
 - b. “information impactedness”—we don't know what the cost of obtaining information is
 - c. firms are hierarchies (governance structures) to resolve conflicts
 - d. firms create their own internal rules and structures
3. Douglass Cecil North (Washington, St. Louis) *Institutions, Institutional Change, and Economic Performance* (1990)
 - a. institutions include both formal rule and informal norms
 - b. institutions don't necessarily reduce transaction costs
 - c. institutions determine economic growth rates
 - d. changes in institutions come from changes in relative prices
 - i. population changes
 - ii. information cost changes
 - iii. intentional change by parties to a transaction
 - e. changes in norms can be from changes in ideas and ideology
 - f. Classic examples: U.S. vs. Latin America, Great Britain vs. Spain
4. Avner Grief (Stanford) *Institutions and the Path to the Modern Economy: Lessons from Medieval Trade* (2006)
 - a. applies game theory to institutions
 - b. re-emphasizes that equilibria can be reached which are low and which limit economic growth
5. Elinor Ostrom (Indiana) *Governing the Commons: The Evolution of Institutions for Collective Action* (1990)
 - a. Hardin is wrong; most situations aren't open, unrestricted access
 - b. complex institutions govern common pool resources
 - c. Olson was right; enforcement is easier with small groups
 - d. Some institutions adapt to change (technology, price, etc.)
 - e. there are many types of institutional arrangements

- i. private property
- ii. government property
- iii. community property

B. Other key terms and concepts

- 1. social capital—social networks have economic value
- 2. asymmetric information—(Joseph Stiglitz) not everyone has all the information, the information I have I may not want you to know
- 3. bounded rationality—it is not worth the investment of time and money to acquire certain types of information

IV. Principal-Agent Theory

A. Principal—the Contractor, Agent—the Contracted

B. Agency costs—the transaction costs of enforcing a contract

C. Moral hazard—the agent knows more than the principal (information asymmetry) and can take hidden (unobservable) action that may harm the principal

- 1. example: insurance—since I no longer bear the full costs of the risk, I take more risks

D. Adverse selection—the risk that those who are the worse agents and the ones who will most be interested in the contract

- a. example: insurance—the sickest people are the ones most interested in health insurance; employment—the worse employees want the jobs that provide the most job security

- 1. Screening—the techniques the principal uses before a contract to try to learn about the agent (banks screen their borrowers)
- 2. Signalling—the agent tries to convey information to the principal (a job applicant gets an M.A. from Patterson School)

E. Economic Man vs. Administrative Man

1. Herbert Simon *Models of Man* (1957)

- a. economic man has all the information and makes rational decisions taking into account efficiency
- b. administrative man “satisfices” by taking the first satisfactory solution

F. Incentives and management

- 1. effectiveness (outcomes) vs. efficiency (behavior)

G. Control mechanisms

- 1. before-the-fact: demand-concealing, unique and hard to monitor
- 2. after-the-fact: demand-revealing, specify rewards and consequences, homogenous consequences, easy to monitor

V. Poverty measurement

A. Who are we concerned with?

- 1. Absolute poverty or relative poverty
- 2. Temporary poverty or chronic poverty
- 3. Households or individuals

B. The Poverty Line “a critical threshold of income, consumption, or more generally, access to goods and services below which individuals are declared to be poor.” (Ray 1998)

- 1. nutrition-based poverty lines—based on a number of calories or nutrients
 - a. U.S. Orshansky (1963) work determines poverty is anything below 3

times the income sufficient to purchase a minimum budget for food requirements

2. Can also be based on % of mean income, minimum wage, full account of what it costs to stay alive (nutrition, shelter, clothing)
3. The Head Count Ratio ($HCR = HC/n$)
 - a. %age of the population below the poverty line
 - b. problem—doesn't tell us how far below the poverty line
4. The Poverty Gap Ratio (PGR)
 - a. average income shortfall from the poverty line divided by how much of an average income it takes to fill the gap
5. The Income Gap Ration
 - a. the takes the income shortfall and then multiplies it by the number of poor; a measure of how much income the poor have to gain

C. Measurements of Inequality

1. Principles of measurement
 - a. The anonymity principle—it doesn't matter who earns the income
 - b. The population principle—proportions, not overall size is what's important
 - c. Relative income principle—it's relative poverty, not absolute
 - d. The Dalton principle— Hugh Dalton (LSE) (1920) regressive transfers (from poorer to richer) should lead to less equal income distributions; more unequal if we can move income from richer to poorer and still maintain disparities
2. The Lorenz curve—a curve examining the % of a population that controls the % of income for that population
 - a. problem: can't rank
3. the Kuznets ratio—Simon Kuznets (Penn), pieces of the Lorenz curve, x% of population controls x% of income
4. the coefficient of variation—based on standard deviations from the mean, meets all 4 principles
5. The Gini coefficient—Corrado Gini (1912) takes differences between all pairs of incomes, meets all four principles

VI. Last notes

- A. Engel's law—as income goes up, we'll consume different commodities (more fruits, vegetables, meat, higher levels of food safety, higher quality goods)
- B. Intra-household distribution
 1. men and women spend money differently—women typically invest more in health, children's nutrition and education
 - a. This is why micro-finance targets women
 2. Age can be another factor
- C. DFID's Sustainable Livelihoods Framework
 1. different types of capital—human, natural, social, physical, financial
 2. different strategies for livelihoods