Saving Rates and Poverty

The Role of Conspicuous Consumption and Human Capital

· Poor families around the world spend a large fraction of their income on consumption of goods that appear to be useless in alleviating poverty while saving at very low rates and neglecting investment in health and education.

This Paper:

 We offer an explanation for this observation, based on a trade-off between conspicuous consumption and human capital as signals for income.

Why does income inequality persist?

Lack of education leads to lack of human capital

Poor nutrition: means underdevelopment and inability to work

Social networks: can lead to lack of self belief

Extractive institutions have an incentive to keep the poor, poor (kleptocracy)

Credit constraints: inability to invest in human capital

Location is endogenous: neighbourhood effect

-the poor reside in an area, so it stays poor and opportunities decrease.

Land-locked country

Conspicuous Consumption: social norms form traditions (Tajikistan)

Networks and persistence: religion/ contraception/ fertility

Becker (1964): quality/ quantity trade-off of children

Temptation: individuals maximise their utility function, which is more harmful amongst the poor

Model which generates a poverty trap



Because average is above threshold, higher inequality country is more wealthy.

A low threshold means more equal countries have higher fraction of families trapped in poverty/ converging to the low income steady-state.

Can change result if we move average income below threshold

Poor countries have a larger supply of unskilled labour.

gap between low skilled UK and Indian is relatively large.

Poverty persists and is difficult to escape

Need endogenous wages

Market Imperfection/ Credit Constraint approach

Political Economy approach

Median income is always below mean income

Median voter theorem implies that higher inequality means there is more pressure for income distribution

-when taxes increase there is an effect on incentives, however.

Scandanavian/ homogeneous countries have higher taxation

Equality of income generates equality of opportunity

Although there is a belief that inequality is beneficial

-in the Solow model, the key to growth is accumulation of capital: Rich save at a higher rate

Physical versus Human capital

It is easier to distinguish usage of physical capital than human capital (non-observable)

Human capital has strong decreasing returns at the the individual level

However, a country cannot grow just by investing in physical capital

? (2004) find that in terms of the accumulation over time of physical and human capital, initially, physical capital is the main engine of growth, but eventually human capital becomes the main driver, and equality of income is actually more beneficial.

The wealthy reject general redistribution but prefer workers to be more educated (National Efficiency Argument

 Poor families around the world spend a large fraction of their income on consumption of goods that appear to be useless in alleviating poverty while saving at very low rates and neglecting investment in health and education.

Evidence of this from **Banerjee-Duflo (2007)** which shows that the poor people typically:

scarcely invest in their children's education

are poorly fed

suffer from health problems

- are worried and anxious to an extent that interferes with their sleep and work
- fail to make trivial investments in their businesses
- save so little that they cannot avoid cutting on their meals when they suffer a temporary decline in income

Yet they spend a large fraction of their income on alcohol, cigarettes, and festivals, among other goods that seem useless in alleviating poverty

The New York Times (May 22, 2010) "Moonshine or the Kids?"

 The reporter argues that "if the poorest families spent as much money educating their children as they do on wine, cigarettes and prostitutes, their children's prospects would be transformed".

The Obamza family from Congo say they cannot afford the \$2.50 a month tuition for their children But Mr and Mrs Obamza spend over \$20 a month on alcohol and cell phones

Bloch-Rao-Desai (2004) emphasise the prestige motive underlying marriage expenses. They argue that daughter's marriage costs (dowery and celebrations) could add up to six times a family's annual income.

Rao (2001) finds that festivals amount to 15% of households expenditures in rural India.

Case et al. (2008) finds that households in South Africa spend the equivalent of a year's income for an adult's funeral.

Tajikistan's President banned gold teeth, the use of cell phones in universities and big birthday parties; because he was aware of the adverse effects of competing with their neighbour's for prestige

He criticised wealthy citizens for showing off their wealth and setting a high standard for others, who spent their life saving on a wedding just to compete with their neighbours.

Charles-Hurst-Roussanov (2009) found that college educated spent about 13% less than their high school educated counterparts on visible expenditures,

Pinker (2003) believed status was in our genes, and conspicuous consumption is universal.

Wilson-Daly (2004) found that pretty women inspire men to discount the future more strongly

Griskevicius et al. (2007) found that mating goals in men increase their willingness to spend on conspicuous luxuries (and display heroism or dominance). Whereas in women, mating goals boost public helping

Missy Elliott (2004) argued that the bling bling culture of flashy jewellery encourages young black men and women to spend their money irresponsibly. Artists should encourage young people to invest responsibly in stable, long-term assets.

Peacock's tail in evolutionary biology.

Related literature: Conspicuous Consumption

Background:

Veblen (1899) and others Formal models: Study the implications of conspicuous consumption wrt market prices and savings.

Related Literature Notesale.co.uk **Conspicuous Consumption**

Background: Veblen (1899) and others

Formal models: Study the implications pictors consumption wrt market prices and savings.

 Identify positive and negative effects on economic growth.

Notable contributions include: Frank (1985, 1986), Basu (1989), Ireland (1994), Corneo-Jeanne (1994), Glazer-Konrad (1996), Bagwell-Bernheim (1996), Hopkins-Kornienko (2004)

Friedman (1957) found that the observation that rich individuals save more is due to smoothing of consumption

Dynan et al (2004) found that higher lifetime income households save a larger fraction of their permanent income Their findings are inconsistent with the standard life cycle model with homothetic preferences

(also inconsistent with explanations that are based on differences in time preference rates; subsistence consumption and variation in Social Security replacement rates.)

Dynan et al (2004) found that higher lifetime income households save a larger fraction of their permanent income Their findings are consistent with hyperbolic discounting and variation in Social Security replacement rates.

The explanation offered here of conspicuous consumption is also consistent with their finding.