A NEW MEASURE OF ECONOMIC STATUS

The extent to which a society provides aid and opportunities to its least fortunate members depends in part on the society's beliefs regarding the causes of poverty and inequality. While a strong case can be made for aiding the poor irrespective of the source of their poverty, those who oppose increased aid to low income groups frequently justify their position by asserting that the poor themselves are to "blame" for their condition; that is, they are poorer than the rest of us because the rest of us try harder.

To what extent is inequality attributable to differences in opportunity, on the one hand, and to differences in the extent to which people take advantage of their opportunities, on the other? Are the poorest among us poor because they work less or because they have less to work with? In their monograph *Earnings Capacity, Poverty, and Inequality,* Professors Irwin Garfinkel and Robert Haveman address these and other questions by means of a new concept and measure of economic status called "earnings capacity." Earnings capacity, defined as the income stream that would be generated if each household employed its human and physical assets to capacity, is estimated for each individual and family in the population. This estimate of earnings capacity is then compared with actual earnings to see how different groups in the population take advantage of or utilize the capacity they possess.

For the nonaged population—the group for which the notion of capacity utilization is most relevant—Garfinkel and Haveman find that the rate of capacity utilization is about two-thirds if no value is attributed to services in the home produced by spouses and nearly three-fourths if such attribution is made. While the rate of capacity utilization is significantly higher for men than for women, virtually no difference is found between the rates of blacks and whites. Indeed, blacks of a given economic status, by and large, have slightly higher utilization rates than do whites of similar economic status. Also, families of low economic status are found to utilize their capacity at about the same rate as high-status families.

Clearly, differences in work effort among households contribute to observed inequality in the distribution of income. Because estimates of capacity utilization provide an indicator of household work effort, the authors also estimate the extent of the contribution of this phenomenon to income inequality. Comparing the distributions of earnings capacity and pretransfer income, they conclude that at least 80% of the variation in income is caused by factors other than differences in capacity utilization. These factors include education, age, race, and geographic location, but not differences in work effort.

Based on their findings, the authors conclude that those who are poor by the income measure are not in that state because of relative failure on their part to exploit economic capacities. This suggests that neither laziness nor reliance upon public income transfers is responsible for low earnings. To the extent that public income transfer policy is shaped by the belief that the poor do not exploit their capacities—that they are "undeserving"—these findings may ultimately help to reshape such policy.

Garfinkel and Haveman also employ the concept of earnings capacity to develop a definition of poverty based on the capabilities of households rather than on money income. This definition is then used to identify the composition of the earnings capacity poor and to compare it with that of the poor as officially defined. They find that blacks, those who live in large families, and those who live in families with strong attachments to the labor market are more likely to be poor by the capacity-based definition than by the standard definition. The last finding suggests that the inadequate coverage of the working poor provided by our current income maintenance programs may be even less justifable than evaluations that define poverty on the basis of current income have suggested. They also find that families headed by women are just as likely to be poor in terms of earnings capacity as in terms of current income. Thus, even if female heads of families worked at full-time, full-year jobs, they would need support from public income maintenance programs to lift them out of poverty.

Numerous income transfer programs—ranging from the negative income tax to earnings supplements to children's allowances—have been designed to reduce poverty. Because most of these measures are conditioned on income, they target their benefits on the income poor. They tend to be less effective in assisting the earnings capacity poor. The authors analyze how the target effectiveness of 10 income support programs is altered when the definition of poverty is shifted from the official income definition to one based on earnings capacity. They find that the differences among programs in target effectiveness are significantly changed when earnings capacity rather than current income is used as the measure of economic status. In general, universal programs—those which are not conditioned on income

EARNINGS CAPACITY, POVERTY, AND INEQUALITY

by

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level—improve relative ranking in terms of aiding low income groups when earnings capacity is used to define the target group. These results call into question the usefulness of the criterion of target effectiveness based on money income for evaluating income transfer programs.

Finally, the concept of earnings capacity is used to evaluate the contribution of labor market discrimination to black-white earnings differences. The estimates presented lead to several conclusions. If economic status is presumed to be better reflected in earnings capacity than in current income, the disparity between blacks and whites is even greater than income differences imply. Perhaps even more serious, the disparity in status between blacks and whites is greater for low capacity families than for high capacity families. This disparity between the races is caused in large measure by discrimination against blacks in labor markets: Between 43% and 60% of the gap for men and between 30% and 39% of the gap for families is attributable to such discrimination. The authors conclude that policies designed to reduce labor market discrimination should play a prominent role in the overall effort to reduce racial differences in income. Garfinkel and Haveman also examine the degree to which the severity of labor market discrimination varies with earnings capacity and find no clear-cut pattern. They argue, consequently, that there is no justification for focusing antidiscrimination policy on a particular part of the distribution of earnings capacity.

As Robert Lampman notes in his foreword to the book, the earnings capacity study "contributes to the long tradition of research designed to improve the measurement of economic status and inequality, a tradition that has experienced a major increase in interest in the last decade." Lampman also says:

> By criticizing the standard approach to measuring economic position and inequality, and suggesting an alternative to it, the volume fits what Alice Rivlin has termed "forensic social science." Because such an approach does not provide the sorts of arguments and evidence present in a legal brief for the opposition the reader will need to test the authors' arguments as he goes along. . . . For what sorts of policy issues, for instance, is a longer term indicator of economic status, such as earnings capacity, more appropriate than an indicator of current need, such as annual money income? The alert and questioning reader will find this study a challenging one that stimulates reexamination of both social policy goals and social practices.

Used Car Rip-Off
(continued from page 2)

The other is a "rotten dealer" explanation. It is quite plausible that certain dealers consciously seek out the poor in order to exploit them. They may bribe the poor, say, with better credit terms but charge them higher prices and remain unresponsive when defects show up later. As the authors warn:

> If this second explanation for discrimination is true, then disclosure regulation as a strategy for giving leverage to the low-income consumer would be misplaced. It may only increase restrictions on decent dealers who would abide by the law to maintain their reputation, while rotten dealers would continue to ignore the legal regulations in all but the most symbolic ways.

The FTC study shows that direct consumer complaints to government agencies are rare. Of the 220 or so who complained—89% of whom bought from a dealer—only 6 said they had contacted a public remedy agent. However, the study suggests that state inspectors do offer secure benefits for the relatively few consumers who complain officially.

SELECTED PAPER

"On the Efficiency of Income Testing in Tax-Transfer Programs," by Jonathan R. Kesselman and Irwin Garfinkel. Institute for Research on Poverty Discussion Paper no. 339-76.

This paper demonstrates that target efficiency is a conceptually flawed measure of economic efficiency with respect to tax-transfer programs. It thus casts doubt on the widely shared view that income-tested programs are more efficient than non-income-tested ones. To illustrate some quantitative aspects of the economic efficiency of income testing the authors calculate several feasible overlapping negative income taxes and corresponding credit income taxes. They show that the difference in welfare loss between the two types of programs is invariably small—less than one-half of 1% of aggregate earnings. This leads to a major implication for policy formulation—specifically, that any differential economic efficiency costs between a credit income tax (non-income-tested) and a negative income tax (income-tested) may well be dominated by other program differences.

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[1] The nonprofit Center for Public Representation in Madison was founded in 1974 to provide representation for groups of citizens whose lack of organization or resources prevent them from financing their own representation before state and local administrative agencies. The Center engages in advocacy, research, and citizen education. It also trains law students through a clinical placement program that provides experiences in state and local administrative law and public interest advocacy, while helping them to develop a substantive knowledge of crucial areas of law.