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PERCSPECTIVES ON POLICY

POVERTY IN THE U.S.

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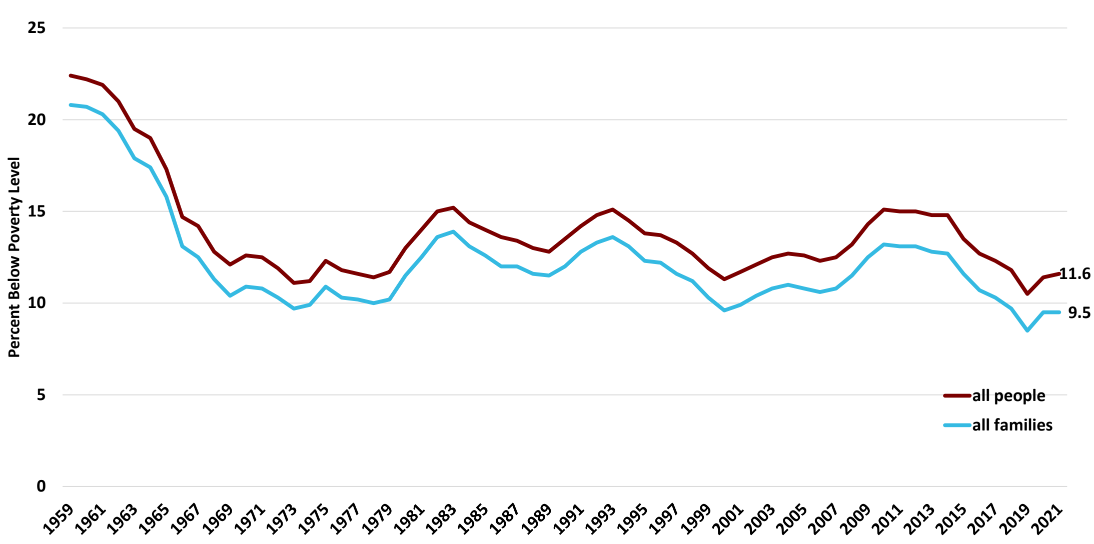
During his 1964 State of the Union Address, President Lyndon B. Johnson declared war on poverty. Since that declaration, the poverty rate has declined from 19% to 11.6% in 2021 with ups and downs along the way. From 1966 to 2021, the poverty rate ranged from a low of 10.5% to a high of 15.2%, not a terribly wide range, given the business cycles the economy has been through. But one may wonder why the poverty rate has not dropped even further than it has in a rich country like the United States.

Some of the answer lies in how poverty is measured in the U.S., some of the answer lies in whether poverty is conceptually an absolute or relative measure, and some lies in the way people respond to the programs designed to address poverty.

Let's begin with the way poverty is measured in the U.S. The official poverty thresholds were developed by Mollie Orshansky who worked for the Social Security Administration. The poverty thresholds she identified were based on multiples of low-cost food plans for families of different sizes. The first poverty estimates were published in 1967 and have been updated annually using the Consumer Price Index. Families' incomes are compared to the thresholds to determine whether they are considered poor. The Census definition of money income includes labor earnings, interest, dividends, rents, and trusts. It includes unemployment, workers' compensation, disability payments, monetary public assistance, survivors' benefits, child support and alimony. It also includes retirement payments from Social Security, Supplemental Security Income, pensions, and other retirement income.

However, money income does not include health care benefits like Medicaid, tax credits like the Earned Income Tax Credit, in-kind benefits like housing subsidies, and food assistance through programs like the Supplemental Nutrition Assistance Program, the School Lunch Program, and the Women, Infants, and Children program. Comparing the poverty threshold to money income, therefore, underestimates the resources available to lower income Americans.

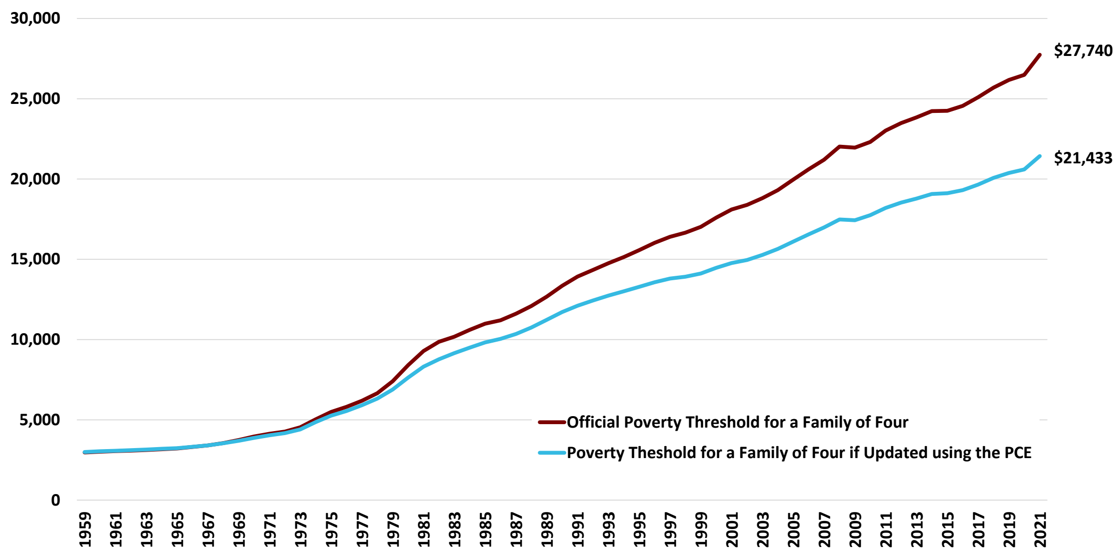
FIGURE 1. POVERTY STATUS OF ALL PEOPLE AND ALL FAMILIES, 1959-2021



Source: US Bureau of the Census, Current Population Survey, Annual Social and Economic Supplements, https://www.census.gov/data/tables/time-series/demo/income-poverty/cps-pov/pov-01.html

Another problem with the poverty threshold is how it is updated each year with the Consumer Price Index for all urban consumers (CPI-U). The CPI-U is known to overstate inflation because it prices a fixed basket of goods that does not allow for substitution to other goods as relative prices change and because it does not adjust dynamically for changes in quality and the introduction of new goods. An alternative price index is the Personal Consumption Expenditures (PCE) price index. By construction, the PCE overcomes some of the CPI's shortcomings and it is the index preferred by the Federal Reserve in determining whether its policies are keeping the inflation rate close to 2%. Since 1959, the average annual inflation rate as measured by the CPI is 3.7%, while the average as measured by the PCE index is 3.3%. This relatively small difference matters over time. The figure below illustrates the lower the poverty threshold over time for a family of four had the PCE been used to update the threshold amount rather than the CPI. By 2021 the threshold would have been $21,433 rather than $27,740, or 23% lower.

FIGURE 2. POVERTY THRESHOLDS: TWO DIFFERENT COST OF LIVING ADJUSTMENTS



Source: US Bureau of the Census, Table 1. https://www.census.gov/data/tables/time-series/demo/income-poverty/historical-poverty-people.html#par_list PCE from U.S. Bureau of Economic Analysis, Personal Consumption Expenditures: Chain-type Price Index [PCEPI], retrieved from FRED, Federal Reserve Bank of St. Louis. (1967 = 1)

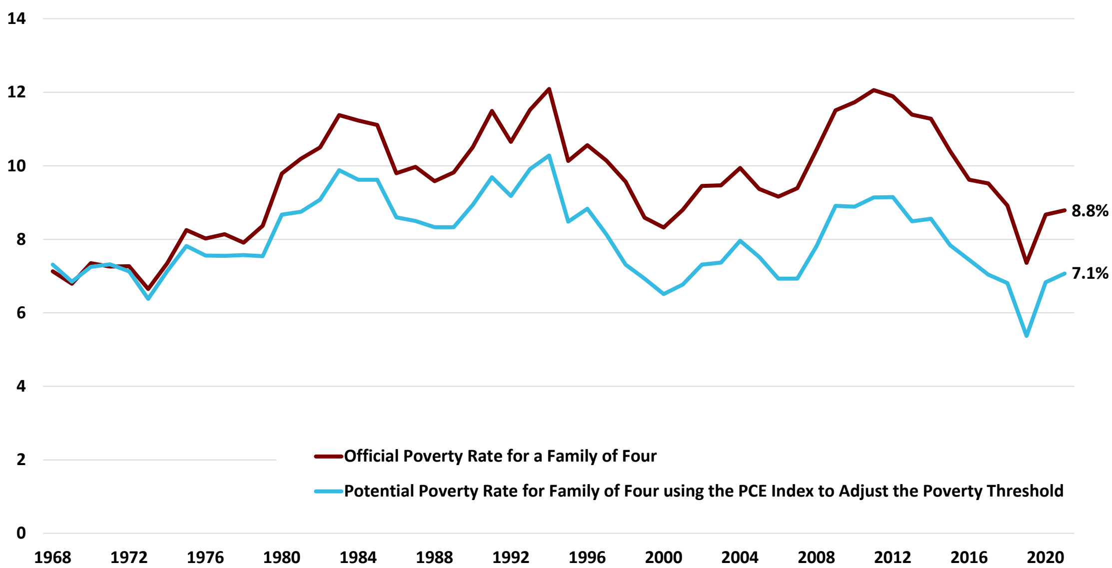
Had the poverty threshold been updated using the PCE index, and assuming no behavioral responses from those who receive benefits from anti-poverty programs, the percentage of the population below the poverty line would be lower. The next figure identifies the poverty rate for families of four using the official poverty threshold and a potential poverty rate had the poverty threshold based on the PCE index been in place. The potential poverty rate for people in families of four in 2021is 7.1% compared to the official rate of 8.8%. We note that this is the potential poverty rate, given that eligibility for most programs aimed at addressing poverty is tied in some way to the poverty threshold. Because the programs' designs alter individuals' economic incentives, the actual change in the poverty rate is contingent on workers' responses to those changed incentives.

Additionally, given that anti-poverty programs affect peoples' incentives, their observed labor market responses are altered relative to their behavior in the absence of the program. Economists assume individuals maximize their satisfaction subject to their budget constraint. The aforementioned means-tested federal programs alter peoples' budget constraint in that the programs' resources are available to lower income workers, but the amounts that people are eligible to receive are phased-out as income rises. The resources essentially provide extra income, and the phase-out range effectively lowers the affected workers' wages over that range of income. This reduces these workers' hours in the labor force and their resulting labor income relative to the respective amounts in the absence of the programs. Apart from the phase-in portion of the Earned Income Tax Credit, which actually raises affected workers' wages, the programs have the effect of lowering participants' hours of work and their earnings from work and thereby they can increase earned income inequality even though they are intended to reduce inequality. Importantly, the share of adults between the ages of 18 and 64 who are in poverty and who do not work rose from 50% in 1976 to 66% in 2021.

Thus, when identifying poverty and inequality, we really need to ask whether we are measuring poverty and inequality based on individuals' and families' incomes and resources before or after taxes and transfers where the transfers include both means-tested transfers and transfers to retirees in the form of Medicare and Social Security benefits.

The Congressional Budget Office (CBO) regularly

FIGURE 3. PERCENT OF PEOPLE IN FAMILIES OF FOUR IN POVERTY BASED ON ALTERNATIVE THRESHOLDS



Source: Bureau of Labor Statistics, estimated using the Current Population Survey, March Supplements.

estimates the degree to which taxes and transfers affect inequality. In its latest report from November 2022, the CBO found that after accounting for taxes and transfer payments the inflation-adjusted income of families in the lowest quintile grew 94% between 1979 and 2019, families in the middle three quintiles saw a much smaller increase of only 59%, and families in the top quintile saw a 123% increase. The CBO also reports that the average value of means-tested programs' transfers to families in the lowest quintile grew from 32% of their income before taxes and transfers in 1979 to 64% in 2019. This rise was driven in large part by the increase in Medicaid spending and the program's expanded eligibility.

Inequality is often measured using the Gini Coefficient, a statistic the ranges from 0 to 1. Values closer to 0 reflect lower inequality while values closer to 1 indicate higher inequality. The CBO found that the Gini Coefficient based on market income, before any taxes or any transfers, grew from 0.472 to 0.592, or by 0.12, from 1979 and 2019. However, the Gini Coefficient based on income after transfers and taxes grew from 0.352 to 0.432, or 0.08, from 1979 to 2019. After adjusting for transfers and taxes the Gini coefficients are lower (27% lower in 2019) and the rate of growth in inequality is reduced.

Phil Gramm, Robert Ekelund and John Early (2022) find that after adjusting for transfers and taxes the Gini coefficient fell 3% between 1947 and 2017.

Researchers Bruce Meyer and James Sullivan (2023) take a related, but different approach in analyzing inequality by focusing on consumption inequality – including the value of transfers. They find that income inequality measured as the ratio of income for families at the 90th percentile divided by income at the 10th grew 25% from the early 1960s to 2017. In contrast, they found that the 90th/10th ratio based on consumption rather than income only grew 9.5%.

We are now in the 60th year of the war on poverty. As we have seen, accounting for the value of the transfers and taxes greatly reduces inequality and its growth. However, we have also discussed how the receipt of transfers and the payment of taxes affect individual's incentives. Policies that encourage skill development and work provide the best prospects for reducing inequality in the long run.

Congressional Budget Office, The Distribution of Household Income, 2019, November 2022. www.cbo.gov/publication/58353

Gramm, Phil, Robert Ekelund, and John Early, *The Myth of American Inequality*, Rowman&Littlefield, 2022.

Meyer, Bruce D. and Jame X. Sullivan, Consumption and Income Inequality in the United States since the 1960s, *Journal of Political Economy,* February 2023.

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