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Are income poverty and perceptions of financial difficulties dynamically interrelated?

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ABSTRACT

An individual's economic ill fare can be assessed both *objectively*, looking at one's income with reference to a poverty line, or *subjectively*, on the basis of the individual's perceived experience of financial difficulties. Although these are distinct perspectives, income poverty and perceptions of financial difficulties are likely to be interrelated. Low income (especially if it persists) is likely to negatively affect perceptions of financial difficulties and, as recently suggested by the behavioural economics literature, (past) subjective sentiment may in return influence individual's income generating ability and poverty status. The aim of this paper is to determine the extent of these dynamic cross-effects between both processes. Using Luxembourg survey data, our main result highlights the existence of a feedback effect from past perceived financial difficulties on current income poverty suggesting that subjective perceptions can have objective effects on an individual's behaviour and outcomes.

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1. Introduction

The economic ill fare of an individual can be measured in several ways. The conventional income poverty approach aims at determining *objectively* whether an individual's income falls short of a pre-defined poverty line. Concern about this approach is sometimes expressed for practical reasons, such as measurement error in income (Nicoletti et al., 2011) or difficulties in identifying relevant poverty lines or equivalence scales (Ravallion, 1996). In addition, objective approaches may miss part of the problem. For example, Bourguignon (2006) highlights the following paradox in developed countries: while the presence of an efficient redistributive system contributed to the reduction of (absolute) poverty, a 'feeling' of poverty is still often reported in some population subgroups such as beneficiaries of minimum income guarantee programmes. Receiving social assistance may even amplify this feeling in cases where individuals feel stigmatized. Therefore, the concept of poverty or welfare cannot be reduced to the single criterion of low income. One of the alternatives consists of relying on *subjective* information about the experienced level of financial difficulties to assess an individual's ill fare (Deaton, 2010).

Income-based and perceptions-based approaches aim at measuring financial inadequacy from different angles.[2] Inherent differences at the core of these two approaches suggest that they are clearly distinct concepts. Objective income poverty focuses

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[2] In relation to perceptions-based approaches, this paper focuses on the topic of financial subjective well-being rather than on broader concepts such as life satisfaction or happiness (van Praag et al., 2003).

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on the means at the disposal of an individual to achieve a certain level of well-being (Sen, 1979) and is a function of an individual's income and needs. Perceptions of financial difficulties are also a function of an individual's income and needs, but are determined by additional factors such as an individual's spending, other types of resources or needs and aspirations. The concepts of resources and needs used in both approaches are different. While the income-based approach only takes into account the differences in needs arising from differences in household composition and size through an equivalence scale, and may exclude various resources (such as wealth), individuals may keep these other elements in mind when answering subjective questions. Therefore, factors affecting the spending of a household (e.g. a free childcare policy), some of its resources (e.g. assets accumulation), needs (e.g. disability related) or aspirations may alter the perception of financial difficulties, but not necessarily income poverty. What if we consider both concepts simultaneously?

Indeed, despite being distinct concepts highlighting different dimensions of disadvantage, income poverty and perceived financial difficulties are likely to be dynamically interrelated. First, it may seem natural that the current objective situation unveiled by the income poverty approach directly influences an individual's perceptions of their financial difficulties. In addition, the interrelation between both concepts may happen through feedback effects of the past on the present (Biewen, 2009). For instance, an individual's past perceptions of financial difficulties may affect their income-generating abilities, which might then impact on their current poverty status. In turn, the lasting effects of the previous poverty status may affect the current perception of financial difficulties. Therefore, both situations may play a role in the incidence or amplification of the intensity of the other. Our current empirical knowledge about the dynamic interrelation of these two concepts, which requires the joint modelling of both approaches, is limited. The aim of this paper is to determine whether there are dynamic cross-effects between both processes and to contribute to the literature on the effect of subjective variables on objective outcomes.

The channels through which perceived financial difficulties may affect future income poverty may be found in the recent and growing literature on the behavioural economics approach to poverty (Bertrand et al., 2004; Duflo, 2006). Departing from the standard neoclassical approach, the behavioural approach to poverty suggests that "poverty changes the set of options available to individuals. Poverty thus affects behaviour, even if the decision maker is 'neo-classical': unboundedly rational, forward looking, and internally consistent. The homo economicus at the core of neo-classical economics ('calculating, unemotional maximizer' [...]) would behave differently if he was poor than if he was rich" (Duflo, 2006, pg. 367). Recent findings about the negative effect of *scarcity*, defined as *having less than what you feel you need*, on cognitive abilities, executive control and decision-making process provide credible channels through which subjective perceptions may affect the objective situation of individuals (Mullainathan and Shafir, 2013; Haushofer and Fehr, 2014). The latter is a result also highlighted by De Neve et al. (2013, chap. 4, pg. 70) who report that "existing scientific evidence indicates that subjective well-being has an objective impact across a broad range of behavioural traits and life outcomes, and does not simply follow from them. In fact, we observe the existence of a *dynamic* relationship between happiness and other important aspects of our lives with effects running in both directions" (see also De Neve and Oswald, 2012).[3] Our paper contributes to this literature by assessing whether perceptions of financial 'scarcity' may affect the objective situation of income poverty experienced by individuals.

Our empirical illustration is based on Luxembourg data. Following the development of the financial sector since the middle of the 1980s, Luxembourg became one of the world richest countries in terms of GDP per capita (Fusco et al., 2014). It may then appear surprising to devote efforts to studying financial difficulties in this country. However, it can also be argued that subjective approaches bring valuable information that can be relevant precisely in rich countries such as Luxembourg, given that they are likely to capture the feeling of social exclusion referred to by Bourguignon (2006). In addition, individuals living in rich countries may have higher aspirations due to a higher reference point determined by social comparisons (Stutzer, 2004). Genicot and Ray (2014) demonstrate how unmet aspirations, and therefore perceived financial difficulties, may generate frustration and induce lower investments.[4] This lower investment can influence an individual's future income which constitutes another possible explanation for the feedback effect.

As well established in the literature, both income poverty (see among others Cappellari and Jenkins, 2004; Jenkins, 2013) and perceived financial difficulties (Pudney, 2008; Kaya, 2014) are affected by a considerable degree of state dependence. This concept refers to the question as to whether a process is autoregressive, that is, in our case, the extent to which being poor in a given moment increases *by itself* the probability of being poor in the future (Heckman, 2001; Skrondal and Rabe-Hesketh, 2014).[5] Regarding income poverty, this empirical regularity can be explained by the fact that experiencing poverty may modify individuals' preferences, constraints or ability that will increase their risk of being income poor in the future compared to an identical individual that did not experience poverty in the first place. The mechanisms driving such a genuine effect

[3] In the same vein, Cobb-Clark et al. (2013) show how the locus of control affects savings and wealth accumulation, which can affect future income and poverty status. Other channels exist such as loss of motivation, stigma or negative effects of financial difficulties on psychological health (Rojas, 2011 or Taylor et al., 2011).

[4] Genicot and Ray (2014, pg. 1) argue that "'best aspirations are those that lie at a moderate distance from the individual's current economic situation standards, large enough to incentivize but not so large as to induce frustration. [...] The argument captures both encouragement and frustration, and on its own can be used to create an aspirations-based theory of poverty traps."

[5] State dependence and feedback effects refer in fact to two behavioural effects involving the impact of the past on the present. In the case of happiness, Bottan and Perez Truglia (2011) make the distinction between two channels of habituation: *general habituation* (or satisfaction treadmill) refers to genuine state dependence while *specific habituation* (or hedonic treadmill) refers to habituation to specific lagged effects of life events. For an analysis of the adaptation of happiness to poverty see Clark et al. (2016).

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