Prospects of upward mobility and preferences for redistribution: Evidence from the Life in Transition Survey

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ABSTRACT

This paper investigates empirically the link between the prospects of upward mobility and preferences for redistribution using data for a large number of countries from the Life in Transition Survey. The survey is unique in that it provides a detailed account of expected future mobility, and makes it possible to differentiate respondents by their degree of risk aversion — both key pillars of the POUM model. The results from the pooled sample, and those for the EU member states confirm the theoretical predictions of Benabou and Ok (2001) — individuals' expectations of upward mobility reduce their preference for redistribution, but only when the degree of risk aversion is low. The POUM hypothesis is not borne out by the data in the non-EU countries.

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1. Introduction

Benabou and Ok (2001) propose a theoretical model in which the prospect of upward mobility (POUM) for individuals who are poorer than average, and in particular the expectation of being richer than average in the future, can lead them to oppose lasting redistribution, provided that voters have a reasonably low level of risk aversion, are reasonably farsighted, and that fiscal policy set today can be expected to persist into future periods. The force of their model resides in its ability to account, for instance, for the greater redistributive propensity of European governments vis-a-vis the United States despite lower levels of income inequality in Europe (OECD, 2008) — empirical results that are counter to the standard models such as Meltzer and Richard (1981).[1]

This paper aims to empirically assess the POUM hypothesis based on nationally-representative data from the Life in Transition Survey (LiTS), which covers a large set of European and former Socialist countries. Its primary contribution to the existing empirical studies of the POUM hypothesis (Ravallion and Lokshin, 2000; Checchi and Filippin, 2004; Alesina and La Ferrara, 2005; Alesina and Giuliano, 2009) derives from the fact that the LiTS dataset (i) provides precise measures of future mobility expectations; and (ii) allows us to distinguish between redistributive preferences of upwardly mobile groups that differ in their

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[1] Alesina, DiTella and MacCulloch (2004) find that higher income inequality has a negative effect on life satisfaction in Europe but not in the United States, and suggest that the difference is due to perceptions of higher social mobility in the United States. For an alternative explanation of the differences in the extent of redistribution between Europe and the United States, which highlights differences in preferences for leisure, see Hodler (2008).

degree of risk aversion. Both are crucial building blocks of the POUM model proposed by Benabou and Ok (2001), and ones that previous studies are unable to capture in a precise way.[2]

In addition, this study complements the existing POUM studies by looking at EU member countries and non-EU former Socialist states. To my knowledge this is the first study to investigate the relationship between social mobility and redistributive preferences for a large set of Eastern European countries. Ravallion and Lokshin (2000) provide some evidence based on Russian data from the mid-1990s, whereas Alesina and La Ferrara (2005) and Alesina and Giuliano (2009) focus on the US.[3]

The estimates based on the pooled LiTS sample suggest that the prospects of upward mobility are indeed associated with a lower preference for redistribution, but only if the degree of risk aversion is low. Those with a high degree of risk aversion, despite their expectations of future upward mobility, remain similar in their preferences for redistribution to those who are below average on the welfare ladder today and expect to remain so in the future. This result is in line with the POUM hypothesis. Further, the POUM hypothesis is also confirmed for the sub-sample of countries that are EU members, whereas in non-EU countries the individuals who are below average on the welfare ladder today but expect to be above average in the future do not exhibit lower preferences for redistribution, an outcome that could be due to the lower predictability of the future policy context in these countries.

The rest of the paper is structured as follows: Section 2 briefly describes the existing empirical studies that test the POUM hypothesis. Section 3 discusses the data used in the analysis and outlines the empirical strategy. The results of the empirical analysis are described in Section 4. Section 5 concludes.

2. The POUM hypothesis: earlier empirical studies

While there is a large empirical literature on the various personal and institutional factors that affect redistributive preferences, only a few of the existing studies implement empirical tests of the POUM hypothesis. This is primarily due to the limitations of existing data. In their study, Benabou and Ok (2001) note that the POUM hypothesis rests on three premises: "The first is that policies chosen today will, to some extent, persist into future periods. Some degree of inertia or commitment power in the setting of fiscal policy seems quite reasonable. The second assumption is that agents are not too risk averse, for otherwise they must realize that redistribution provides valuable insurance against the fact that their income may go down as well as up. The third and key premise is that individuals or families who are currently *poorer than average* — for instance, the median voter — expect to become *richer than average*." (Benabou and Ok, 2001: p.448, italics in original).

Checchi and Filippin (2004) suggest that it is difficult to implement a test of the POUM hypothesis based on observational data because one needs to have data for a number of components including (i) the degree of risk aversion; (ii) the current (income) position of the respondent; (iii) expectations of future (income) position; (iv) expectations regarding the persistence of distributive policy. Household surveys normally do not capture all of the above data, and especially data on individual risk aversion.

In addition, the literature on redistributive preferences suggests a number of other determinants of such preferences that need to be taken into consideration if one wanted to disentangle mobility expectations from other confounding factors. For instance, Piketty (1995) points to the need also to account for factors like past mobility and beliefs about effort and luck as determinants of success. Alesina and Angeletos (2005) note that beliefs about the fairness of social competition and determinants of income inequality can play an important role (see also Galasso, 2003). A number of recent studies find that redistributive preferences are influenced by factors such as beliefs about hard work and luck, perceptions of fairness, past mobility, religion, political ideology, cultural norms or social capital (Corneo and Gruner, 2002; Fong, 2001; Alesina and La Ferrara, 2005; Bernasconi, 2006; Alesina and Fuchs-Schuendeln, 2007; Hodler, 2008; Alesina and Giuliano, 2009; Luttmer and Singhal, 2011; Kuhn, 2011; Yamamura, 2012).[4]

Checci and Filippin overcome these difficulties by testing the POUM hypothesis in a setting in which they experimentally vary the concavity of the mobility process, the degree of social mobility, the knowledge of personal income and the degree of inequality, while controlling for the degree of risk aversion and inequality aversion. They find that the preferred taxation level declines when transition matrices are characterized by POUM, that is when an individual below average income has an above average expected income for the next period.

As noted in the Introduction, several studies that use observational data to explore the relationship between social mobility and redistributive preferences exist, although none benefit from data that make it possible to meet all of the requirements pointed out by Checchi and Filippin (2004). Alesina and La Ferrara (2005), who find support for the POUM hypothesis based on GSS data, are able to account for the beliefs regarding the importance of effort and luck for success, but they can only rely on proxies such as whether an individual is self-employed or has been unemployed during the past 5 years to try to capture differences in risk preferences across individuals.

Another problematic aspect of the study by Alesina and La Ferrara (2005) has to do with the fact that expectations of future mobility are constructed from objective transition probabilities imputed into their data from the Panel Study of Income Dynamics

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[2] The exception to this is Checchi and Filippin (2004), which accounts for all model components by design in an experimental setting, but their conclusions are drawn based on a sample of 95 university students from the University of Milan.

[3] Alesina and Giuliano (2009) include data on Transition Economies from the World Values Survey, they only comment briefly on their being more redistributive than other countries in their data, while their test of the POUM hypothesis is based entirely on the General Social Survey (GSS) data from the US.

[4] These studies focus primarily on the individual attributes that affect preferences for redistribution. For a recent review of some of the institutional factors (e.g. electoral competition or multidimensional policy space) that can explain limited redistribution see Harms and Zink (2003) and references therein.