Poverty and Inequality in a 'Principles of Economics' Textbook

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The new economics textbook *The Economy*, by the Curriculum Open-access Resources in Economics Team or the CORE Team is discussed from the point of view of introducing students to the topic of poverty and inequality. It is argued that mainstream textbooks adopt a framework that reduces the explanations largely to luck, choice, or ability. The new book, by paying careful attention to frictions in the economic institutions that underpin the market economy, provides an alternative framework where inequality of opportunity becomes clear and visible.

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What did you learn in school today
Dear little boy of mine?
What did you learn in school today
Dear little boy of mine?

I learned that markets always clear
I learned that the economy's efficient and fair
I learned that the poor are stupid or lazy
And that's what the teacher said to me

I learned that everybody's rational
I learned that markets seldom fail
I learned that taxes should be low
For jobs and GDP to grow

I learned that everything's got a price
I learned that corporations are nice
I learned that welfare promotes vice
And redistribution is just slice and dice

That's what I learned in school today
That's what I learned in school.

(With due apologies to Tom Paxton.)

My parody of the song "What Did You Learn In School Today?" by Tom Paxton popularised by Pete Seeger, while tongue-in-cheek, is perhaps not too far off the mark from summarising the main lessons that an introductory course in economics offers: prices move to equilibrate supply and demand; everyone is rational and does what is best for them; the competitive market outcome is efficient; and attempts by the government to deal with poverty by redistributing income can be counterproductive due to the negative effects of taxes on growth and of welfare on work incentives.

Principles of Economics

When you read an introductory textbook for the first time as a student, it seems like a fountainhead of objective truth lit by the glow of wisdom. Only with the distance of time and your own intellectual journey do you begin to see the pieces that are missing or outdated, the biases, the hidden assumptions, and the glaring gaps between conventional wisdom and emerging evidence.

Paul Samuelson's *Economics*, originally published in 1948, is the first modern textbook on economics. It has then progressed through 19 different editions, the most recent one being in 2009. I remember reading it in the summer before I started college. I loved the breezy style and its breathtaking scope of integrating neoclassical price theory with Keynesian macroeconomics, its vision of a modern welfare state that supposedly takes the best elements of capitalism and socialism, and lucid discussions of specific topics such as international trade, economic growth, and public finance. However, growing up in a developing country with the grim reality of poverty and inequality all around made it hard to ignore the fact that neither the market nor the government in India worked even remotely in ways that could be related to the framework of the book.

One of the big questions that motivated a teenager growing up in a developing country like me to study economics, and continues to motivate many others to do so is this: Why are some people so poor and some so rich? Are the poor just like the non-poor in terms of their potential but simply operate in a more adverse environment, in terms of individual circumstances or economy-wide characteristics? Are there self-corrective forces at work, for example, the poor working hard and saving their way out of poverty, or are these particularly weak in developing countries?

It is not that Samuelson's book did not have any discussion relating to these questions, but the basic approach was that of growth theory where the problem of development is essentially one of accumulating capital stock through savings and investment. Given diminishing returns, the poor are supposed to catch up with the rich eventually: just like children grow faster, while the growth of adults slows down. Framed this way, long-run differences in the standard of living of individuals can only be reflecting differences in preferences (such as attitude to work or savings behaviour) or productivity.

These conclusions seemed to be at odds with the world around me. The poorest individuals seemed to work the hardest and my experience of teaching poor children in a Calcutta (now Kolkata) slum the summer before joining college convinced me that there was no difference in terms of raw ability between them and children from more privileged backgrounds. Yet they all seemed headed to dropping out from school soon to join the informal labour market as child labour. The glaring inequality of opportunity that this environment suggested seemed a million miles away from the textbook model of forward-looking rational agents and competitive markets. This left a lingering dissatisfaction in my mind about the relevance of such a framework—despite its elegance, internal coherence, and broadness—to the reality of an economy like that of India. It is like riding a fast car on a United States (US) highway and then visualising driving it in a crowded Indian city with roads that have potholes and pedestrians and drivers who hardly follow traffic rules.

Even though I have never taught a "principles-style" course in my subsequent career as an academic economist, I kept following popular textbooks with interest. Other than the latest (19th) edition of Samuelson's textbook (co-authored with William D Nordhaus, 2009, McGraw-Hill Irwin), I find the *Principles of Economics* by N Gregory Mankiw to be an excellent example of a mainstream textbook in the tradition of Samuelson's pioneering textbook. However, even in the latest edition of the book (8th Edition 2017), the core conceptual framework has not changed much from Samuelson's. It involves two key elements: a representative economic agent who is fully informed, rational and forward-looking, and makes decisions as a consumer, producer, or worker; and competitive markets that coordinate between the decisions of millions of atomistic economic agents through prices.

Yet to understand poverty or inequality, whether among individuals and households within a country or their variation across countries or over time, this framework does not take us very far. After all, in contrast to per capita or average income, the very concepts of inequality or poverty correspond to a distribution of individuals and so the representative agent framework cannot go very far by definition. Moreover, any serious discussion of inequality of opportunity—those with the same potential reaching very different economic outcomes—must depart from the assumptions that economic agents are rational and fully-informed or that markets are perfect. Otherwise, like in the parody at the beginning, we must fall back on preferences (the poor are not hard-working or forward-looking enough), ability, or luck to explain poverty. After all, if markets are well-functioning and individuals are rational, it seems logical that economic outcomes would tend to be efficient and redistributive policies involving taxes and welfare would tend to have the inevitable equity–efficiency trade-off. Indeed, the treatment of inequality and poverty in Mankiw (2017: Chapter 20) revolves around luck, ability, effort, and the possible disincentive effects of welfare.

To be fair, as much as a map is an abstract and stylised depiction of geographic space, conceptual frameworks are bound to be stylised and simplified to have any traction at explaining anything. The challenge in both cases is not to be realistic but to be useful for certain purposes. My point is that the core conceptual framework in mainstream economics textbooks may well be useful for a range of questions but is not very helpful in the context of explaining poverty and inequality. Can one think of an alternative principles-style textbook where market failure is weaved seamlessly into the benchmark model, as opposed to being presented as an anomaly in a separate chapter? And can that be related in a convincing way to the problems of poverty and inequality of opportunity that are the first-order problems facing an overwhelming majority of people on this planet?

The Economy's Approach

The Economy—Economics for a Changing World by the Curriculum Open-access Resources in Economics (CORE) Team led by Samuel Bowles, Wendy Carlin, and Margaret Stevens, provides an alternative model of a principles textbook that suggests that this is not only possible, but can be done in a compelling way. This 1,100-page book with 22 chapters gives a panoramic view of modern economics that will be of use not only to first-year undergraduate students—the intended audience for the book—but also to anybody interested in an introduction or a quick reference to the subject.

Its choice of topics is motivated by surveying students as to the most pressing problems that economists should address. It is interesting that "inequality" was the most popular answer to the question across current undergraduate students as well as recent graduates working as policy economists in central banks across the world. Clearly, the financial crisis of 2008 had a role to play here. It created widespread discontent with inequality as not being the result of a competitive process that results in gainers and losers, but a rigged system where gains to rich investors are private, but losses are underwritten by society. Following that, Thomas Piketty's 2014 book, *Capital in the 21st Century*, an unlikely bestseller for an academic book dense with facts and figures, put inequality at the centre of public discussion by documenting the rise of sharp income inequality in the developed world since the 1970s.

On the topic of inequality, the book starts in the very first chapter (Unit 1) with graphs and figures about the distribution of income within and between countries, and a discussion of the economic institutions that underpin a market economy. Unit 19, which is devoted to the topic of inequality, includes a comprehensive discussion of various notions of inequality, stylised facts on inequality drawing on the work of Piketty and others, and alternative policies to deal with it. It brings together tools and concepts developed in the intervening chapters that deal with how economic institutions affect the balance of power in economic transactions (Unit 5); how because of contracting and informational frictions, credit markets tend not to behave in the way suggested by the standard supply–demand and market-clearing approach (Unit 10); and a more general treatment of market failure and policies to deal with it (Unit 12).

Let me illustrate how this approach provides a natural explanation for inequality resulting from inequality of opportunity as opposed to choices, luck, or ability. Consider credit markets: a transaction in the credit market is not a spot trade like buying an apple from the fruit seller. Rather, the borrower gets some money while the lender merely gets a promise of repayment. As a result, an institutional mechanism is needed to ensure that promises are kept, ranging from credit-rating and collateral to legal methods of debt recovery. Unfortunately, this creates a natural entry barrier for the poor who do not own many assets and so are perceived as higher risk borrowers. As a result, they face greater barriers to enter professions or businesses, or to acquire skills that require large capital investments.

In this world, two individuals with identical preferences and abilities can end up with very different levels of income if they start with different wealth levels. Also, policies to relax the barriers that the poor face in the credit market would serve the objectives of both equity (for the obvious reasons) as well as efficiency (because now there is a better match between ability and resources).

This example suggests that studying the causes and consequences of market failures may be an obvious starting point to answer at least some of the most important questions of interest to economists. Yet in the aforementioned mainstream principles textbooks there is little discussion of market failure beyond the routine discussion of monopoly, monopolistic competition, and oligopoly as arising from the exclusive ownership of some resource, economies of scale, or government regulation. They are presented as aberrations and not inherent in the hidden wiring and circuitry of economic institutions that underpin the grand abstraction called the "market economy" relating to property rights, transactions, and contracting, as well as the flow of information.

This approach not only provides a natural explanation for market failures in the context of credit in general, but also why this problem is likely to be more severe in developing countries with their imperfect legal systems and rampant political interference in the economic domain—after all, even if someone owns an asset, he or she does not necessarily have a formal title to it, which limits its potential role as collateral.

To me this is an example that illustrates the major strength of the CORE textbook: its ability to seamlessly stitch together a convincing picture of a market economy where a framework based on the rational agent and perfectly competitive markets framework is viewed as an exception rather than the rule, even though it has its uses as a conceptual benchmark. After all, to answer the questions about poverty and inequality that motivate many to study economics, one must start with economies that are "imperfect," just as to understand illness one cannot only study healthy people.

Another strength of the book is motivating the conceptual topics by empirical facts rather than the other way round. And, perhaps appropriately for a book that is motivated by inequality, it is available free online and the paperback version is available at a much lower price than other books like *Principles of Economics*. Given the reported royalties of popular undergraduate textbooks in economics, it is just as well that a textbook motivated by inequality and having a comprehensive treatment of it is not directly contributing to it.