STATUS AND POVERTY

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Abstract
We present a model in which individuals' preferences are defined over their consumption, transfers to offspring, and social status ~~is~~ associated with income. We show that a separating equilibrium exists where individuals' expenditure on conspicuous consumption is a signal for their unobserved income. In this equilibrium, poor families that climb up the social ladder by the accumulation of wealth engage in conspicuous consumption that prevents them from escaping poverty. Our model may explain why the poor make some choices that do not appear to help them escape poverty. (JEL: D91, O11, O12, O15)

1. Introduction

We present an overlapping generations model in which individuals' preferences are defined over their consumption, transfers to their offspring that are invested in human capital, and social status ~~is~~ associated with income. We study the evolution of income within a dynasty and show that conspicuous consumption, which is a signal for unobserved income, may give rise to a poverty trap.

In particular, an individual's status is defined by the social inferences about the individual's unobservable income. These social inferences are based on the individual's conspicuous consumption, which does not enter the utility function directly, but provides a signal about income. We show the existence of a "binary"

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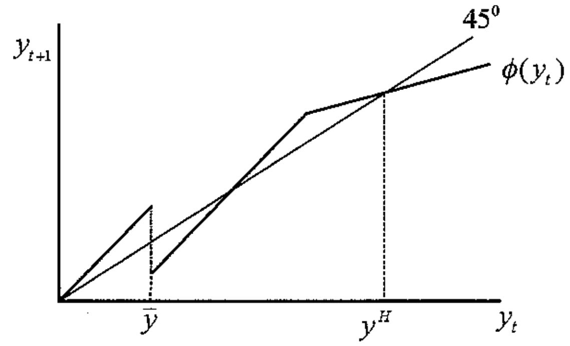

FIGURE 1. The evolution of income.

It is assumed that for $e < \bar{e}$ the marginal return to human capital γ is larger than the marginal return to physical capital R and that the wage rate per unit of human capital is set to one, or

$$\gamma > R. \qquad \text{(Assumption 1)}$$

This assumption ensures that individuals invest in human capital.

Under assumption 1, the second period income of an individual who is born in time t, denoted y_{t+1}, is uniquely determined by the bequest received by this individual, denoted b_t, in the following way:

$$y_{t+1} = y(b_t) \equiv \begin{cases} \gamma b_t & \text{if } b_t < \bar{e}, \\ \gamma \bar{e} + R(b_t - \bar{e}) & \text{if } b_t \geq \bar{e}. \end{cases} \tag{10}$$

Hence, it follows from equations (8) and (10) that the evolution of income within a dynasty is uniquely determined. That is, y_{t+1} is uniquely determined

Figure 1 given y_t by the following dynamical system, depicted in Figure 1:

$$y_{t+1} = \phi(y_t) = \begin{cases} \gamma \beta y_t & \text{if } y_t < \bar{y}, \\ \gamma \beta (y_t - \bar{x})) & \text{if } y_t \in [\bar{y}, \bar{e}/\beta + \bar{x}], \\ \gamma \bar{e} + R(\beta(y_t - \bar{x}) - \bar{e}) & \text{if } y_t > \bar{e}/\beta + \bar{x}, \end{cases} \tag{11}$$

where y_0 is given per dynasty (note that $\beta(y_t - \bar{x}) < \bar{e}$ if and only if $y_t < \bar{e}/\beta + \bar{x}$).

Additional restrictions on the parameter values are required in order for the dynamical system to generate multiple income level steady states. The first two such restrictions are

$$\beta\gamma > 1 \quad \text{and} \quad \beta R < 1. \qquad \text{(Assumption 2)}$$