

5E

EDUCATOR

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MISSION

The *5E Educator* provides secondary teachers with content to enhance understanding of economics and personal finance. It also offers lesson plans and Federal Reserve resources to reinforce state and local curriculum. We seek to enrich the learning experience for students and highlight the importance of economics and financial literacy in the process of everyday decision-making.

To sign up to receive the online *5E Educator*, visit:
www.richmondfed.org/publications/education/5e_educator

Dear Educators,



In this issue of the *5E Educator*, we have chosen to examine the issue of poverty by asking several important questions: What does it mean to live in poverty? How is poverty measured? How does poverty in the United States compare to poverty abroad? Why do some countries thrive while others do not? These are not necessarily new questions. But the perspectives for answering these questions and for tackling the problem have typically varied by the professional discipline—economics, anthropology, human geography and political science—and the country asking them.

In our featured article, we also look at who bears responsibility for addressing the problem of poverty. For instance,

should wealthier countries help poorer countries gain wealth? What should be the form and extent of that help? What role do political, economic and legal institutions play in those efforts?

We hope that by shedding light on this international issue, we provoke thought and meaningful classroom discussion for you and your students.

Regards,

Jeffrey M. Lacker

President

Federal Reserve Bank of Richmond



Hallway Monitor

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Class in Session

Why Aren't All Countries Rich?

This article excerpt is from the Richmond Fed's second quarter 2011 issue of Region Focus, written by Federal Reserve Bank of Richmond economics writer, Jessie Romero. The views expressed in this article are those of the author and do not necessarily reflect the views of the Federal Reserve Bank of Richmond or the Federal Reserve System.

The numbers are disheartening. As of 2005, according to the World Bank, 2.6 billion people were living on less than \$2 per day. Of those, 1.4 billion live in severe poverty, on less than \$1.25 per day, without access to electricity, clean water, basic medicines, elementary education, or even enough food. Why do some countries thrive while others fail?

Economists have pondered that question since Adam Smith published *An Inquiry into the Causes of the Wealth of Nations* in 1776, but there is still considerable debate about what poor countries should do to become rich and what rich countries should do to assist them. It is clear that sound legal, political, and economic institutions are essential to economic growth, but it is less clear how countries can acquire them — and how to feed and educate their citizens in the meantime.

Rich countries became that way for one of two reasons: either they have more resources than poorer countries do, or they have institutions that allow them to put their resources to effective use. Development work in the 1950s and 1960s was driven by the former belief, but the evidence suggests that institutions are what matters.

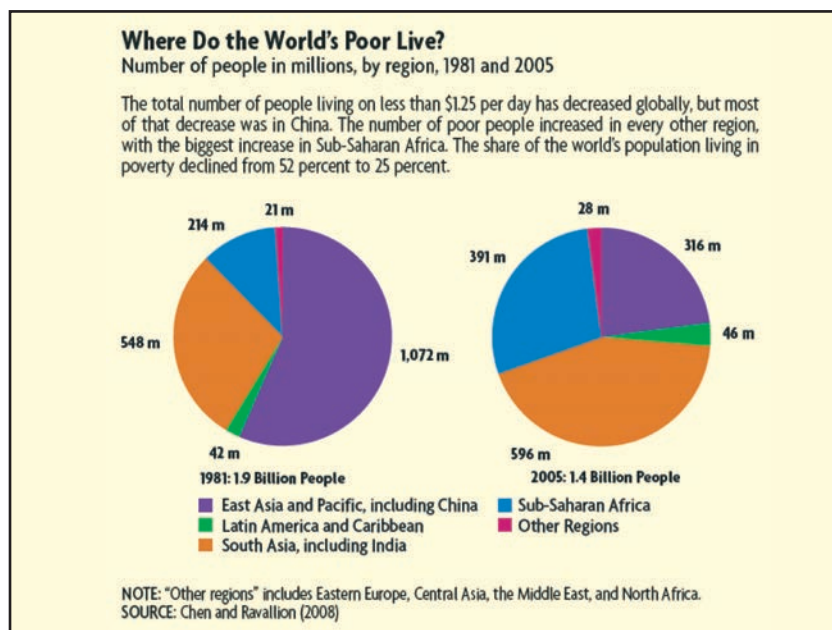
Economic growth requires cooperation; individuals and firms must come to agreements about how to organize themselves in order to realize the gains of specialization and trade. Such cooperation requires incentives, and

those incentives require legal systems that enforce contracts and property rights, and economic policies that limit predatory behavior by governments and firms.

Why do countries in close proximity, with similar endowments of natural resources, often have drastically different outcomes? The difference is the national border, which marks the boundary between one set of institutions and another. Unfortunately, as the late Mancur Olson noted, "The intricate social cooperation that emerges when there is a sophisticated array of markets requires far better institutions and economic policies than most countries have." Abundant resources may actually lead to a "resource curse," the paradox that, on average, countries with a wealth of natural resources lag far behind countries with fewer natural resources. Despite having an estimated \$24 trillion in untapped mineral deposits, for example, the Congo is one of the poorest countries in the world. One explanation for the curse is the so-called Dutch disease, whereby a boom in a commodity export (in the case of the Dutch, natural gas) leads to declines in other sectors of the economy, such as manufacturing and agriculture.

Institutions can help countries escape the resource curse. For instance, diamonds have made Botswana one of the richest countries in Africa. Its strong democratic government developed a productive relationship with the diamond company De Beers, in contrast to the exploitative relationships that often exist when governments are weak or corrupt. Botswana exemplifies the difference between producer-friendly and "grabber-friendly" countries, as Halvor Mehlum and Karl Moene of the University of Oslo and Ragnar Torvik of the Norwegian University of Science and Technology describe in a 2006 paper. They find that weak or absent institutions create incentives for entrepreneurs to specialize in rent-seeking, vote-buying, and violence, aka "grabbing." Where there are sound institutions, however, entrepreneurs specialize in production, and the country can profit from its natural resources.

Development also may depend on a country's geography and its degree of integration with the rest of the world. Countries engaged in international trade may be highly developed because they have greater access to technical knowledge and foreign capital. But recent empirical work by Dani Rodrik





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and Francesco Trebbi substantiates the idea that “institutions rule.” They find that geography and integration do have an effect on income, but only through their influence on institutional quality; once institutions are controlled for, the effect disappears. Institutional quality trumps the other factors; a country may draw the short end of the geographical straw, but still prosper if it has strong institutions. Still, the complex links between people, communities, governments, and nations make it difficult to tease out cause and effect. Economists and policymakers on all sides of the debates continue to search for answers, motivated by the same thing: making life better for 2.6 billion people.

Inequality and Development

In an early attempt to link growth and inequality, Nobel laureate Simon Kuznets used data from the United States, the United Kingdom and Germany in a 1955 *American Economic Review* paper. He found that the relationship followed an inverted “U” shape: at low levels of per capita income, growth leads to increasing income inequality, which then decreases as the country reaches higher levels of income and more workers transition to higher-skill, better-paying jobs. The “Kuznets curve” is often interpreted as implying that greater inequality may be a necessary, but temporary, trade-off on the path of development. Many development experts believe the Kuznets curve means that the poor are left behind by economic growth, especially when countries are starting from very low bases, but recent research suggests that growth does raise the incomes of the poor.

Rich countries also worry about inequality. A forum held by the OECD discussed the widening income inequality in its member countries, and many commentators in the United States are concerned about the growing share of total income taken home by the top 1 percent of earners. This disparity may contribute to a host of social problems, including

moderate-income households spending beyond their means in order to “keep up with the Joneses,” leading to higher divorce and bankruptcy rates, according to economist Robert Frank of Cornell University. Others make the argument that “a rising tide lifts all boats,” noting that although the tide has risen more rapidly

for the rich, living standards overall have increased dramatically.

For the complete article and related readings:

www.richmondfed.org/publications/research/region_focus/2011/q2/pdf/feature3.pdf

How is poverty measured?

Poverty rates are generally expressed as the percentage of a population that falls below a determined absolute or relative poverty threshold. Absolute poverty thresholds are expressed as the income below that which is necessary to sustain a defined level of food/energy subsistence or as the income below that necessary to support consumption of adequate housing, a dietary standard and satisfactory health. According to the National Academy of Sciences, “Absolute thresholds are fixed at a point in time and updated solely for price changes.” In contrast, relative thresholds are expressly tied to the living standards of the whole community and are generally expressed as some percentage of average income for the population.¹

The U.S. Annual Poverty threshold, calculated using Census Bureau and Current Population Survey (CPS) data, is an example of an absolute measure.² In 1963, a Social Security Administration economist and statistician developed the first U.S. poverty threshold based on the total dollar price of the Agriculture Department’s economy food plan and the average percentage of after-tax income spent on food. This 1963 threshold was designated as the base poverty threshold and has been adjusted upward for inflation each year to determine current year annual poverty thresholds.³

The current approach to calculating the U.S. poverty thresholds is not without critique. In 1995, the National Academy of Sciences released a report, *Measuring Poverty: A New Approach*, to address the following weaknesses in the current measure:

- The current measure does not account for certain factors that can influence household consumption, including income and payroll taxes and in-kind benefits such as food stamps and Medicaid.
- The current measure does not take into account differences in cost of living across the country.

According to the Census Bureau, in 2009 an Interagency Technical Working Group was charged with laying the foundation to facilitate development of a Supplemental Poverty Measure (SPM) by the Census Bureau, in cooperation with the Bureau of Labor Statistics. The SPM would not replace the official poverty measure but would serve as an experimental poverty measure that would address some of the weaknesses in the official measure. The latest update on the SPM from the Census Bureau indicates that the fiscal year 2011 federal budget did not include the funding requested by the President for the SPM initiative, and therefore the Census Bureau and the Bureau of Labor Statistics do not currently have the resources needed to move the SPM from research mode to production mode.

For more information on current SPM research, including information on how the proposed SPM stacks up against the official U.S. poverty measure, follow this link:

www.census.gov/hhes/povmeas/index.html.

Looking for an activity that examines various dimensions of a country's growth and development from a global perspective?

Consider the **"Why Aren't All Countries Rich?" Conundrum** — a critical thinking and synthesis exercise designed for high school students to examine perspectives on growth and development.

This activity is especially suited to high school students in world history, U.S. government and IB/AP economics. Teachers can limit the number of statements used to ensure that the activity corresponds with students' reading ability and text application.

Activity Objective: Using information from the article, textbooks or online research, students defend or refute the following statements to examine economic growth and development from a variety of perspectives. By examining each statement, students will gain insight into those variables that affect growth and development.

CEE Content Standard 17: Costs of government policies sometimes exceed benefits.

CEE Content Standard 18: A nation's overall levels of income, employment and prices are determined by the interaction of spending and production decisions made by all households, firms, government agencies and others in the economy.

Materials:

- One copy of the "Why Aren't All Countries Rich?" Conundrum activity for each student.
- Computer access with Internet capability for teachers who add an online research and support component to this lesson.

Procedure:

1. Distribute the "Why Aren't All Countries Rich?" Conundrum handout to students.
2. The class will need access to a computer lab with Internet capability if online research is included in the assignment.
3. Direct students to defend or refute the following statements using the "Why Aren't All Countries Rich?" article, classroom texts or online research.
4. Remind students to use evidence from the article, textbooks or online research to support their responses.
5. Lead a classroom discussion using student responses and research to highlight the points raised in the featured articles.

Student Handout #1

The "Why Aren't All Countries Rich?" Conundrum

Student Directions:

Defend or refute each of the following statements based on information contained in the article, in classroom texts or found through online research. Please note that it is important to provide supporting details even if you agree with a statement.

1. Rich countries are wealthy because they have more resources than poor countries.
2. Rich countries are able to use their resources more effectively than poor countries.
3. Rich countries have more developed institutions than poorer nations.
4. Poor nations lack access to the capital investment available in richer countries.
5. Poor nations are that way because of their geographic locations.
6. Poor nations are more likely to have entrepreneurs that specialize in rent-seeking, vote-buying and violence.
7. Nations that do not integrate or trade with the rest of the world tend to have higher poverty rates.
8. The lack of private property rights and well-functioning markets are key reasons poor nations remain poor.
9. Access to education, healthcare and food are critical ingredients to reducing poverty.
10. Providing credible methods to assess whether countries are meeting poverty reduction goals is the only way to guarantee that aid is making a difference.



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Economic Growth and Development: Perspectives for Policymakers

This excerpt is from the “Summary of the 2006 Philadelphia Fed Policy Forum” written by Loretta J. Mester, executive vice president and director of Research, and focuses on the sessions that discussed the relationship between institutional arrangements and economic growth and development. The views expressed in this article are those of the authors and do not necessarily reflect the views of the Federal Reserve Bank of Richmond or the Federal Reserve System.

Most economists agree that economic growth is the driver of a country’s standard of living. But what drives economic growth? What programs and policies are effective at promoting economic development and the reduction of poverty, and how is effectiveness best determined? Have there been unforeseen consequences of policies that we need to bear in mind when designing new programs? These were some of the questions addressed in the 2006 Policy Forum.

The final session of the forum focused on the role of institutions in fostering economic growth. Most economists recognize the importance of economic growth in reducing poverty in the developing world, of domestic policy choices in determining economic outcomes in poor nations, and of market-friendly, fiscally responsible policies in generating economic growth. The challenge has been to translate these principles into effective policies.

In the view of Dani Rodrik of the Kennedy School of Government, Harvard University, the lesson is that the general principles of good policy do not map into specific policies. To devise effective policies, policymakers must do a lot of context-specific analysis. It is easier

to specify the functions that good institutional arrangements perform than to specify the form they must take. For example, successful countries have, among other things, provided effective protection of property rights and contract enforcement, maintained macroeconomic stability, sought to integrate into the world economy via trade and investment, and provided effective prudential regulation of financial intermediaries. However, these do not translate directly into a unique set of policies.

Reforms have to be well-targeted to work within the political and other constraints in a country. Finally, the process must be ongoing. Institutions must be continually strengthened, and binding constraints that arise later must be addressed. A once-and-for-all reform may ignite growth but is unlikely to sustain it.

Ross Levine, of Brown University, elaborated on the role of the financial system in reducing poverty. In his view, much of the world has financial system policies that limit the poor’s access to the financial system, and this harms the financial system’s ability to improve the welfare of the poor. A large body of research suggests that a well-functioning financial system — one that seeks out entrepreneurs and projects, finances those with the highest expected returns, and monitors those investments — helps improve economic growth by improving capital allocation. Note that this type of financial system does not advocate equality of outcomes, but it does tend to equalize opportunities.

But does a well-functioning financial system help the poor? The research suggests the answer is yes. Across many countries and over a long period (1960-2001), there is a strong positive relationship between the level of private credit as a share of GDP (a measure of

financial development) and the growth of income of the poorest 20 percent of the population, controlling for average economic growth in the country and other country traits.

Recent research suggests that most policies create both winners and losers, and to be effective at reducing poverty, policies must recognize this fact. Forum participants discussed the importance of economic growth, institutions, globalization and financial market development in reducing poverty and income inequality. The discussion underscored the value of continued rigorous economic modeling and empirical research in developing policies to reduce the number of people who are living in poverty worldwide.

For the complete forum summary and references:

www.philadelphiafed.org/research-and-data/publications/business-review/2007/q3/mester_perspectives-for-policymakers.pdf



Beyond the Textbook

Consider using the following resources to introduce your students to the various approaches to poverty measurement and development.

Lesson Plan Ideas: High School

Is Capitalism Good for the Poor?

Audience: High School

Interested in a comprehensive five lesson unit that examines the nuances of poverty, measurement and policy implications? Check out the Foundation for Teaching Economics curriculum that offers a number of activities that cover concepts such as poverty, capitalism, economic growth, income distribution, markets, property rights and rule of law. This unit includes instructional videos. www.fte.org/teacher-resources/lesson-plans/is-capitalism-good-for-the-poor

The views expressed in this unit are those of the authors and do not necessarily reflect the views of the Federal Reserve Bank of Richmond or the Federal Reserve System.

Additional Resources

- Interested in comparing poverty rates within the Federal Reserve Bank of Richmond's region? The March 2011 issue of the *5th District Footprint* provides a geographic snapshot of poverty rates in Fifth District jurisdictions (Maryland, Virginia, parts of West Virginia, North Carolina, South Carolina and D.C.) at the county level. www.richmondfed.org/publications/community_development/5th_district_footprint/2011/footprint_201103.cfm
- This link connects to a short video that examines how poverty is measured, and is appropriate for most middle school and high school audiences. The video is found on the front page of the World Bank's Poverty Reduction and Equity page in the Multimedia section, right hand corner of the page.

www.worldbank.org/poverty
www.youtube.com/watch?v=mFHctW3zQgg&feature=relmfu

- Consider developing a web quest that examines the U.S. Census Bureau's report on "Areas with Concentrated Poverty: 2006-2010." www.census.gov/prod/2011pubs/acsbr10-17.pdf
- Looking for additional content on absolute and relative poverty measures? Check out "Using the Consumer Expenditure Survey to Teach Poverty Measurement" by Amy McCormick Diduch found in *The Journal of Economic Education*, 43 (1), 2012, on page 99-106. The article also features an interesting activity that may be appropriate for AP Microeconomics students.

Visit Us: Fed Experience and Office Tours

Tours are currently available in the Richmond and Baltimore offices. Tours in the Charlotte office are temporarily suspended and expected to resume in fall 2012.

Richmond

The Fed Experience is an interactive, multimedia exhibit where visitors explore their connection to the economy, the growth of living standards over time and the role of the Fed in the economy. The Fed Experience is open to the public and there is no charge to visit. For more information or to schedule a visit, go to thefedexperience.org.

Baltimore

Tours include an instruction session and are available to students (high school and college). For more information or to schedule a classroom visit, please call (410) 576-3441.



Heard over the P.A.

The *5E Educator* features information on recent and upcoming workshops and other events that may be of interest to secondary educators. For the latest information, please visit our conference and events page: www.richmondfed.org/conferences_and_events/education

Event	Date	Location
N.C. Social Studies Conference	2/23–24	Greensboro, N.C.
Capture the Capital Scavenger Hunt	4/21	The Fed Experience, Richmond, Va.
Civics and Economics Personal Financial Literacy Workshop	4/23–24	Charlotte, N.C.
Girl Scouts Experience the Fed	6/19	The Fed Experience, Richmond, Va.
Md. Financial Education Summit	6/20	Timonium, Md.
S.C. Education and Business Summit	6/25–27	Greenville, S.C.
Summer Camp Challenge	7/2–8/10	The Fed Experience, Richmond, Va.
Career and Technical Education Summer Conference	7/24–26	Greensboro, N.C.
Conversation with the Chairman	8/7	Baltimore, Md. (with trip to D.C.) Richmond, Va., Charlotte, N.C.
Va. Jump\$tart Meeting	9/25	Richmond, Va.
Ask the Author — The Panic of 1907: Lessons Learned from the Market's Perfect Storm	9/26	Richmond, Va.
Private School Leadership Conference	9/27	Washington, D.C.
S.C. Social Studies Conference	9/27–29	Greenville, S.C.
Council for Economic Education National Conference	10/4–6	Kansas City, Mo.
Va. Jump\$tart Summit	10/8	Richmond, Va.
Evening @ the Fed Teacher Lecture Series	10/18	Baltimore, Md.
Md. Social Studies Conference	10/19	Baltimore, Md.
Evening @ the Fed Teacher Lecture Series	11/1	Charlotte, N.C.
Va. Social Studies Conference	11/2–3	Williamsburg, Va.
National Council for the Social Studies Conference	11/16–18	Seattle, Wash.

References

How is poverty measured? (p3)

1. "Poverty," published by the U.S. Census Bureau.
www.census.gov/hhes/www/poverty/methods/definitions.html
2. Ibid.
3. "How is poverty measured in the United States?" published by the Institute for Research on Poverty, University of Wisconsin-Madison.
www.irp.wisc.edu/faqs/faq2.htm