

Measure for Measure

Systematic Patterns of Deviation between Income and Consumption as Measures of Welfare in Developing Countries Evidence from a New Dataset

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Abstract

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This paper investigates systematic deviations between the income- and consumption-based measures of welfare drawing on a new database pooling together over twenty Living Standard Measurement Study (LSMS) and other multitopic household surveys from four developing regions.

Measurement of household income is notoriously fraught with problems. As detailed by McKay (2000) in the *Designing Household Survey Questionnaires* book, income is often under-estimated in household surveys as, for example, (i) few written records exist for household businesses and self-employment activities and (ii) individuals and households have incentives to under-report incomes for which they are not paying taxes or which are associated with activities of dubious legality. While it is difficult to establish the extent of the problem, there is some evidence of this under-reporting (McKay, 2000; Coulombe and McKay, 1995). Part of the under-reporting is due to the omission of income components, problems with accurate recording in periods of high inflation, (McKay, 2000), the level of numeracy in the country (Vijverberg and Mead, 2000), or simple non-response to income questions (Scott, Steele and Tilahun, 2005). Recent preliminary work conducted under the Comparative Living Standards Project (CLSP) in the World Bank and cross-country work on Rural Income Generating Activities (RIGA) being carried by the Food and Agriculture Organization (FAO) in collaboration with the World Bank reveals how certain components of income, e.g. agricultural and non-farm business income, are more problematic to quantify than others. These problems are accentuated in developing countries where the share of income from these sources is substantial.

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Irrespective of its limitations, particularly in developing and transition country contexts, income is still used in many countries as a measure of welfare. Traditionally, the majority of countries in Latin America are still basing their poverty figures on income. Countries in Eastern and Central Europe and the Balkans are also slowly moving towards adopting income as a measure of welfare in order to meet some of the statistical requirements for full accession to the European Union. Consequently, given the widespread use of income for measuring poverty and for other analytical purposes, and in view of the existing knowledge gap, it is important to better understand these sources of discrepancy when measuring welfare using the different aggregates.

To the extent that different components of income are measured with different degrees of error, the welfare ranking and profiles of poverty may also vary over time and space due to issues that have more to do with measurement problems than with actual changes/differences in levels of welfare. The paper looks systematically at how income and consumption measures deviate based on (a) the composition of income; (b) the basic characteristics of the survey instruments used in collecting both income and consumption data. Implications for analysis and data collection are drawn.