

Heterogeneous wealth dynamics: On the roles of risk and ability

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Abstract:

This paper studies the causal mechanisms behind poverty traps, building on evidence of nonlinear wealth dynamics among a poor pastoralist population, the Boran from southern Ethiopia. In particular, it explores the roles of adverse weather shocks and individual ability to cope with such shocks in conditioning wealth dynamics. Using original data, we establish pastoralists' expectations of herd dynamics and show both that pastoralists perceive the nonlinear long-term dynamics that characterize livestock wealth in the region and that this pattern results from adverse weather shocks. We estimate a stochastic herd growth frontier that yields herder-specific estimates of unobservable ability on which we then condition our simulations of wealth dynamics. We find that those with lower ability converge to a unique dynamic equilibrium at a small herd size, while those with higher ability exhibit multiple stable dynamic wealth equilibria. Our results underscore the criticality of asset protection against exogenous shocks in order to facilitate wealth accumulation and economic growth and the importance of incorporating indicators of ability in the targeting of asset transfers, as we demonstrate with simulations of alternative asset transfer designs.

Keywords: ability, herd restocking, poverty traps, regression trees, shocks, subjective expectations.

1. Introduction

Contemporary policy debates are rife with discussion of “poverty traps”.¹ There exist several theoretical models that combine some non-convex technology with some market failure to explain why “the poor stay poor and the rich stay rich”.² But do poverty traps exist in the data? The empirical literature has mainly focused on searching for a threshold effect associated with multiple dynamic equilibria in the growth process, with one such equilibrium below a poverty line. The results of such studies remain quite mixed, with some studies (e.g., Dercon 1998, Lybbert et al. 2004, Adato et al. 2006, Barrett et al. 2006) finding support for the hypothesis while others (e.g., McKenzie and Woodruff 2003, Jalan and Ravallion 2004, Lokshin and Ravallion 2004, Antman and McKenzie 2005) find no evidence of such a threshold.

Nonlinear dynamics are sensitive to shocks that perturb their key variables. Not only it is possible to use this feature to test for the presence of growth thresholds (as in Lokshin and Ravallion 2004), but it is possible to conceive that a series of good draws from the distribution of states of nature can move some fortunate individuals above the threshold.³ One contribution of this paper is to emphasize how negative shocks may generate nonlinear dynamics associated with persistent poverty. In particular, we show that we only observe multiple dynamic wealth equilibria among our subject population in adverse states of nature.

¹ See, for example, Sachs (2005) or United Nations Millennium Project (2005).

² See Azariadis and Stachurski (forthcoming) or Bowles et al. (2006) for good reviews of the theoretical and early empirical literature on poverty traps.

³ See Easterly et al.’s (1993) discussion of the effect of “good luck” on cross country growth and the micro evidence on the effects of favorable coffee price shocks on poverty in Uganda (Deininger and Okidi 2003). See Acemoglu and Zilibotti (1997) for a theoretic model where growth is ergodic but poverty can persist.

This paper will also argue that risk is not the only factor shaping wealth dynamics. As the empirical literature on macroeconomic growth suggests, we argue that one needs to consider the possibility of “convergence clubs” based on intrinsic, unobservable characteristics such as time preferences, skills or disabilities.⁴ Perhaps the talented can more easily escape poverty or perhaps the disabled are especially unlikely to do so, regardless of initial wealth. The role unobservable ability plays in determining earnings has long been recognized in, for example, studies of the private returns to education (Card 1995) or in analysis of who becomes an entrepreneur (Evans and Jovanovic 1989). Nevertheless, we know of no other study that explicitly considers the role of individual heterogeneity in shaping wealth dynamics.

These two explanations, risk and ability, may be closely related. It may be that all agents follow a path dynamic that converges towards a high-level equilibrium when faced with favorable states of nature and that low-level equilibria only arise because shocks routinely knock some backwards, before one’s accumulated gains become sufficient to provide adequate self-insurance (Dercon 1998). In that case, risk can be a source of persistent poverty not only because it induces ex ante risk management that causes the poor to choose lower expected return portfolios (Rosenzweig and Binswanger 1993) but because differential ability to cope ex post with shocks may distinguish high performers from their less fortunate counterparts. Thus, variation in welfare dynamics across states of nature may be central to understanding how both individual-level characteristics and initial conditions affect expected welfare dynamics.

⁴ Baumol (1986), DeLong (1988) and Canova (2004) define and discuss the estimation of convergence clubs in macroeconomic growth data.

Finally, the policy implications of the convergence club and threshold-based multiple equilibria mechanisms differ markedly. If poverty is a unique dynamic equilibrium because of immutable individual characteristics, ongoing social transfers may be the only available remedy for an unacceptably low standard of living. But if poverty results from initial asset holdings insufficient to clear a critical minimum endowment threshold and thereby follow a positive accumulation path, then asset transfers or changes to the productivity of existing assets can yield increases in wealth that move beneficiaries onto a different path dynamic, towards a higher-level equilibrium, thereby diminishing the need for ongoing transfers. If both processes are at play within a population, then effective targeting of appropriate interventions depends on identifying the relevant subpopulation to which a given poor household belongs. Sorting out the (potentially multiple) mechanisms that underpin persistent poverty is therefore enormously important in practical terms, but also quite difficult methodologically.

This paper explores these issues empirically. We unpack and extend the results of Lybbert et al. (2004), who analyzed wealth dynamics among Boran pastoralists, a poor population in southern Ethiopia. Cattle are the Boran's major (in many cases, the only non-human) asset and herd evolution is characterized by boom-and-bust cycles determined by drought and biological reproduction. Using 17-year herd history data, Lybbert et al. find herd dynamics that follow an S-shaped curve with two stable dynamic equilibria (at roughly 1 and 35-40 cattle), separated by an unstable dynamic equilibrium, a threshold at 15-20 cattle. The authors conjecture that this threshold results from a minimum critical herd size necessary to undertake migratory herding to deal with spatiotemporal variability in forage and water availability. Those with smaller herds are

forced to stay near their base camps, where pasture conditions soon get degraded, leading to a collapse of herd size towards the low-level stable equilibrium, while those with bigger herds can migrate in search of adequate water and pasture, enabling them to sustain far larger herds. We collected new data among the same population so as to explore the role of shocks and household-specific ability in shaping wealth dynamics.

The next section briefly explains the data. In section 3, we use data on pastoralists' expectations of herd size one year ahead, given different values of initial herd size, to simulate long-run equilibria that correspond closely with those identified in Lybbert et al. (2004). Pastoralists appear to perceive the dynamics reflected in herd history data. We disaggregate these dynamics as a function of respondents' expected rainfall states and find that multiple equilibria arise exclusively in adverse states of nature. Under favorable rainfall regimes, respondents' subjective perceptions suggest a smooth asset growth process towards a unique, high-level dynamic equilibrium. Given manifest variation in expected herd dynamics under adverse states of nature, section 4 explores the hypothesis that herder-specific ability, which we derive using stochastic frontier estimation methods, conditions wealth dynamics. This appears true in both the herders' expectations data and in herd history data. In Section 5 we apply this approach to the analysis of the (expected) evolution of the wealth of a sample of herders in this region. We find evidence that the incorporation of ability does make a difference in terms of expected wealth and inequality in this system. Section 6 concludes, stressing the policy implications of these findings with respect to complex wealth dynamics and the centrality of shocks and individual ability to understanding the existence of multiple equilibria in this system.

2. Data

We employ three data sets. The first is that used by Lybbert et al. (2004), originally collected by and described in Desta (1999), reflecting 17 years of herd histories for 55 Boran pastoralist households drawn from four communities (*woredas*) in southern Ethiopia (Arero, Mega, Negelle and Yabello). Because 16 of the sample households were formed within the 17 year period, this is an uneven panel of data, with 833 total observations. The data were collected using a stratified random sampling design, using detailed interviews held with entire extended families whose collective recall permitted the construction of reliable panel data on herd histories, including mortality, marketing, gifts and loans, slaughtering and calving.⁵

The second consists of household survey data collected from 120 randomly selected Boran pastoralist households in the same four *woredas* of southern Ethiopia, although the respondent households differ from those Desta surveyed. These data were collected every three months, March 2000-June 2002, and then annually each September-October starting in 2003.⁶ The data include rich detail on household composition, educational attainment (although very few respondents are literate or attended any school), migration histories, changes in herds, shocks, etc.

The third data set consists of subjective expectations of herd dynamics we elicited from the PARIMA survey households in 2004. The use of elicited expectations to study decision-making was recently reviewed by Manski (2004). Although the efficacy of

⁵ Prior studies have confirmed the reliability of herd history recall data collected among African pastoralists (Grandin 1983, Assefa 1990, Ensminger 1992).

⁶ The data were collected by the Pastoral Risk Management (PARIMA) project of the USAID Global Livestock Collaborative Research Support Program. Barrett et al. (2004) describe the location, survey methods and available variables.

elicited expectations for testing economic hypotheses has been well established, most such studies have taken place in high-income countries. Important exceptions are Delavande (2004), on the efficacy of contraceptive methods in Ghana, and Luseno et al. (2003) and Lybbert et al. (forthcoming) on pastoralists' rainfall expectations in East Africa. Given the paucity of studies of low-income country respondents' subjective expectations, it is worth explaining in some detail how we elicited these data.

We started by randomly selecting four hypothetical initial herd sizes for each respondent, one from each of the intervals defined by the equilibria identified by Lybbert et al. (2004).⁷ Respondents were then asked their expectations for rainfall next year (choosing between good, normal or bad⁸) and to assume a cattle herd of standard composition for the region (in terms of age and sex of the animals). After thus framing the problem, we asked each respondent to define the maximum and the minimum herd size they would expect to have one year later if they themselves started the year with the randomly assigned initial herd size. These bounds provide a natural anchor for the next step, in which we asked respondents to distribute, on a board, 20 stones among herd sizes between the minimum and the maximum previously elicited, thereby describing their subjective herd size distribution one year ahead conditional on the randomly assigned initial herd size. Finally, each respondent was asked if s/he had ever managed a herd approximately equal in size to the initial value provided as the random seed. The elicitation of the probability distribution function is an appropriate technique under these

⁷ The intervals are [1,5), [5, 15), [15, 40) and [40, 60].

⁸ Published rainfall forecasts, such as those disseminated by the regional Drought Monitoring Centre and government and nongovernmental organization extension officers, use precisely this sort of trinomial rainfall forecast, so it is familiar to respondents (Luseno et al. 2003, Lybbert et al. forthcoming). The data were collected well into the rainy season, hence these are not uninformed priors.

circumstances (Morgan and Henrion 1990) and allows us to compute conditional distributions and their moments.

3. Expected herd dynamics in a stochastic environment

Figure 1 presents the scatter plot and kernel regression⁹ relating expected herd size one year ahead (*herd1*) and initial herd size (*herd0*), conditional on ever having had a herd with a similar size for our sample of 285 observations.¹⁰ The solid, 45-degree line from the origin represents the dynamic equilibria where herd sizes are equal across periods. Three points emerge immediately from comparing pastoralists' subjective expectations of one year-ahead herd dynamics (figure 1) with the dynamics revealed by Desta/Lybbert et al.'s herd history data (the dashed line in figure 2). First, both exhibit multiple dynamic equilibria consistent with the notion of a poverty trap. Second, however, the equilibria identified by pastoralists appear to differ markedly from those apparent in herd history data, both with respect to their location and stability. Notably, herd accumulation occurs for a wider range of initial herd sizes, while herd losses seem a relatively marginal occurrence. This would seem to suggest a different story from the one described by herd history data and detailed studies of the system (Coppock 1994). Finally, there is considerable dispersion in pastoralists' expectations of herd dynamics

⁹ We use the Nadaraya-Watson nonparametric regression, with the Epanechnikov kernel and bandwidth of 4.545. The value of bandwidth was selected using Silverman's (1986) rule of thumb, as determined by the "bounds for Stata" package (Beresteanu and Manski 2000). We apply the same bandwidth choice procedure in the remainder of this paper, unless otherwise noted.

¹⁰ 23 of the 464 total observations (116 respondents with four different starting values each) do not include a herd size prediction, either because respondents were unwilling to make predictions about rainfall or because they were unable to distribute the stones across the board. The latter problem occurred mainly for bigger initial herd sizes, when the difference between the maximum and the minimum was sometimes quite large. Of the remaining 441 observations, in 285 cases (64.6%) the respondents had prior personal experience managing a herd of comparable size.

conditional on a given starting herd size. If one interprets this variation as reflecting pastoralist-specific herding abilities – assuming each pastoralist accurately perceives his or her own herd dynamics given his or her individual aptitude for herding – then this suggests that ability plays a significant role in wealth dynamics.

These casual comparisons invite more careful analysis, especially as regards the intersection of rainfall conditions and herder ability. The pattern exhibited in the actual herd history data (figure 2) is the result of a mixture of environmental conditions over a period of 17 years. Meanwhile, the data on herders' subjective assessments of herd dynamics (figure 1) represent only the year-ahead expectation under necessarily more limited rainfall variability regimes.¹¹ Put differently, the dashed line in figure 2 reflects herd dynamics conditional on rainfall across a varied mixture of states of nature while figure 1 reflects the union of the conditional dynamics with a more limited mixing.

Figures 3a and 3b disaggregate herders' subjective herd dynamics, now conditioning on rainfall expectations. The difference is striking. The relation between expected and initial herd size is nonlinear and suggests multiple equilibria only in the case of bad rainfall conditions. Under good or normal climatic conditions (and perhaps unsurprisingly), herders expect herds to grow no matter the initial herd size. The dispersion around the expected values is also much bigger under conditions of bad rainfall than in a good or normal year. Herders exhibit far more heterogeneous beliefs about their ability to deal with adverse states of nature than with favorable ones. If we

¹¹ For example, Kamara, Swallow and Kirk (2003) identify three major droughts (1984/85, 1991/92 and 1995/96) and two periods of excessive rains (1980/81 and 1997/98) in this region over the period covered by the Desta/Lybbert et al. data. To these natural disasters, one may add the generalized ethnic clashes between the Boran and the Gabra in 1992, following the fall of the Derg regime.

are correct in attributing this feature of the data to individual ability, then such differences seem to matter most when times are tough.

In order to simulate pastoralists' long run expectations of herd dynamics, we need data on the expected behavior under more extreme conditions, namely severe drought and very good years. To obtain such information, we used a second questionnaire similar to the one described above except that we defined rainfall conditions in advance.¹² This instrument was fielded in only one of the four sites (Dida Hara). The results largely correspond with those already reported, showing an almost linear relation between expected and initial herd sizes in very good years and a highly nonlinear relation in cases of severe drought.¹³

In order to generate herders' subjective expectations of herd dynamics under a mixture of states of nature – corresponding to the solid line in figure 2, depicting ten year herd transitions in the Desta/Lybbert et al. data – we need to integrate information on herd growth expectations (i.e., the relation between *herd1* and *herd0*) conditional on rainfall regimes with rainfall data. We therefore simulate using the elicited expectations data previously described and monthly rainfall data for the 4 sites over the period 1991-2001.¹⁴ Since we must predict out-of-sample in simulating herd evolution for large values of initial herd size, we had to estimate the parametric relation between *herd1*

¹² In particular, we asked respondents to consider herd evolution “as if” in 1999, the last major drought, or “as if” in a very good year, which we asked them to define based on their own experience.

¹³ To conserve space, we omit graphics reflecting these data and nonparametric regressions, although plots corresponding to figures 1 and 3 are available upon request.

¹⁴ Average rainfall was 490 mm/year, with a standard deviation of 152 mm/year. Given the skewness and the kurtosis of this distribution, we cannot reject the null hypothesis that rainfall follows a normal distribution. The minimum annual rainfall over the period was registered in 1999 (259 mm) and the maximum in 1997 (765 mm). The probability of such events is 0.064 and 0.035. Given these results, we assumed, for simulation purposes, a symmetric distribution, with a probability of extreme events (drought; or very good year) equal to 0.10.

and *herd0*. Conditional on each of the four rainfall scenarios (drought, poor rainfall, normal/good rainfall, very good), we estimate this relation with a respondent fixed effect specification, α_i , taking advantage of having repeated observations, r , across different herd size intervals on each individual. We thus estimate

$$(1) \quad h_{ir} = f(h_{ir}) + \alpha_i + \varepsilon_{ir}$$

where $f(h_{ir})$ is a polynomial function of initial herd size.¹⁵ Table 1 presents the estimates, which reflect the results displayed visually in figures 1 and 3: unambiguous, effectively linear expected growth under normal/good/very good rainfall conditions, but a nonlinear estimated relation between *herd1* and *herd0* only under conditions of poor rainfall (and drought), and with considerable dispersion so that the precision of those estimates is far less than under favorable rainfall regimes. We then used these estimation results to simulate the expected evolution of herd sizes, properly calibrated to impose basic biological rules for livestock.¹⁶ Figure 4 presents the basic structure of the simulation procedure we used.

Figure 5 presents the mean of 10-year ahead herd size for 500 replicates of this simulation with initial herd sizes between 1 and 60. The results are remarkably similar to the dynamics revealed by the herd history data (solid line in figure 2), both in the general shape of the curve and in the location of the different equilibria. While the one year

¹⁵ Besides the assumptions on the functional form of $f(*)$, we also assumed that $\varepsilon_{ei} \sim N(0, \sigma^2)$. Other specifications, that replace the fixed effect with other regressors that could affect subjective expectations, such as gender, age, experience and migrant status, were considered, but none of those variables proved statistically significant, so we omit these results, which are available upon request. We omit higher order polynomial terms in the very good and good/normal year specifications because they added nothing given the good fit already achieved with a simple linear specification with fixed effects

¹⁶ More precisely, we do not allow for negative herds and impose that biological growth under good rainfall conditions is delayed in 2 years, i.e., enough for cows to reproduce. We also constrain the predicted values for initial herd sizes above 52 (poor rainfall) and 45 (drought) to be linear, with a slope of 0.03309 and 0.00913, preventing unbelievable predictions due to the parameter estimates at the boundaries of our sample.

ahead transitions predicted by the two data sets (figure 1 and the dashed line in figure 2) did not match because of the fundamentally different underlying states of nature, once one takes into account historical rainfall patterns and simulates the longer-term, decadal herd dynamics, it appears that Boran pastoralists have a remarkably accurate understanding of the nature of how their herds evolve. In particular, they expect that someone with a herd below approximately 15 cattle will eventually lose his wealth, collapsing into a destitute equilibrium with 1 animal. Can we be sure that multiple equilibria exist? The answer is “no”; the lower confidence band crosses the equilibrium line only once, from above, at the lower level equilibrium (1 animal). But as we show below, this merely reflects our current assumption that all herders follow the same growth path. Once we allow for the possibility of convergence clubs, the differentiated results become clearer.

Concentrating on our average estimates, do these nonlinearities lead to a poverty trap? The answer depends, in part, on what one means by a “poverty trap”. In Table 2 we quantify the probability of moving between equilibria in a 10 year period given the stochastic nature of these shocks. There is a positive probability that a herder starting with between 1 and 4 cattle will, 10 years later, have grown his herd. Indeed, he may even be above the accumulation threshold. The strictest interpretation of a poverty trap – that initial conditions totally determine future wealth and the system is non-ergodic (and thus the probability of growing is zero) – finds no support in our data. However, the probability of moving out of poverty is quite low (less than 12%), suggesting that, in this context, the idea of a poverty trap is better associated with a high probability (but not certainty) that agents will remain at lower levels of welfare, a weaker but perhaps more

realistic interpretation of the concept, especially in stochastic environments (Azariadis and Stachurski forthcoming).

Figure 6 synthesizes the discussion thus far by presenting the limiting distribution of this stochastic process. The system spends most of its time (78.9 %) with herd sizes below 4 cattle, a consequence of the asymmetric effects of rainfall conditions: the large losses suffered in periods of drought can only be fully compensated by a series of years of good rainfall.¹⁷ With such a small probability of being at the high welfare equilibrium (around 2%), compounded by the fact that such equilibrium is here defined as the residual interval of “herds larger than 40 cattle”, we get a picture of a slow slide into generalized poverty that corresponds with others’ description of the system (Coppock 1994).

Summarizing the results so far, we find that Boran pastoralists accurately perceive long-term herd dynamics characterized by multiple wealth equilibria consistent with the notion of a poverty trap: shocks almost totally prevent wealth accumulation that would allow those herders at a low level of welfare from escaping poverty. However, these dynamics seem entirely the result of an asymmetry in growth rates under different rainfall conditions.¹⁸ Growth is universally expected in good years while S-shaped dynamics seem to result from wealth-differentiated capacity to deal with bad rainfall conditions.

¹⁷ It is possible that this behavior reflects an underestimate of the true probability of remaining in the high welfare equilibrium identified by Lybbert et al (2004), as a consequence of our assumptions regarding herd dynamics outside the range of data for which we have information. Recall that we assumed that, for herd sizes above a certain value and for conditions of poor rainfall or drought, growth rates were a linear function of initial herd size. As we show below, it is possible that that is not the case.

¹⁸ This could explain why, for example, Mogues (2004) studying livestock accumulation in other regions of Ethiopia in the period 2000-03, with no major shocks in between, does not find evidence of such nonlinearities, and why Barrett et al. (2006) find evidence of an S-shaped curve for asset dynamics in the northern Kenya PARIMA sample, which included a major drought ending in 2001.

Our data also show that, even in bad years, not all herders expect their herds to shrink. The considerable interhousehold dispersion of beliefs about herd dynamics under adverse states of nature suggests that herder-specific characteristics, perhaps especially unobserved husbandry skills and related talents we summarize as “ability”, may likewise play a central role in conditioning wealth dynamics among these Ethiopian herders. The next section investigates this hypothesis via two different methods.

4. Ability and expected herd dynamics

Herding is a difficult livelihood. One must know how to treat livestock diseases and injuries, protect cattle against predators, manage their nutrition, navigate to distant grazing and watering sites, assist in difficult calving episodes, etc. Not everyone learns and practices these diverse skills equally well. One would naturally expect more skilled herders to enjoy faster herd growth and to be less subject to adverse shocks to herd size than less skilled herders. Put differently, the herd dynamics explored in Lybbert et al. (2004) and in the previous section may ignore salient differences in herder ability.

We explore the impact of differences in herding ability upon herd dynamics by using the PARIMA panel data on pastoralist households to estimate herder ability using stochastic parametric frontier estimation methods for panel data (Kumbhakar and Lovell 2000). More precisely, we estimate the herd growth frontier conditional on household attributes and initial period herd size using a composed error term that includes a symmetric random component reflecting standard sampling and measurement error, ψ ,

and a one-sided term reflecting observation-specific but time invariant inefficiency, $\phi \geq 0$, which we assume follows a truncated normal distribution, $N^+(\mu, \sigma^2_\mu)$:

$$(2) \quad h_{it} = f(h_{i,t-1}) + \beta X_{it} - \phi_i + \psi_{it}$$

Since these households have been surveyed since 2000, we can take advantage of multiple observations for each herder to compute consistent herder-specific mean efficiency measures, i.e., each pastoralist's proximity to the herd growth frontier that provide at least a coarse proxy for herder-specific ability that is not otherwise directly observable.

Table 3 presents estimates of the herd growth frontier based on 2000-1, 2001-2 and 2002-3 annual observations for the 113 households for which we have complete data on each of the covariates.¹⁹ Table 4 defines these variables and presents the descriptive statistics. Notice that we use an exogenous switching regressions formulation to incorporate the possibility of two different growth paths, depending on whether the herder is above or below the 15 cattle threshold identified by Lybbert et al. (2004). The results indicate statistically significant (p-value = 0.053) differences in the asset dynamics above and below the threshold, with expected herd growth (collapse) above (below) the threshold. The estimated frontier is piecewise quadratic in *herd0-herd1* space, as higher order polynomial terms of lagged herd size have no statistically significant effect.²⁰

¹⁹ Because one of the households is the successor of an initial household, we only have data for the last two years. Hence, we're using an unbalanced panel, with 338 observations.

²⁰ We also ran this regression using cubic and quartic terms, but none of the higher-order polynomials were statistically significantly different from zero and one could not reject the null hypothesis that the higher-order terms jointly have no effect on next period's herd size, once one allows for the threshold effect. The variable "no cattle at t-1" is included to control for the fact that the biology of herd growth is different when one has no cattle – growth can then only occur through purchases or gifts, both of which are very infrequent (Lybbert et al. 2004) – than when one has a positive herd size. Although the point estimate on

Household labor and land endowments have no effect at the margin on expected herd growth, signaling that these are not limiting in this environment for most households. Male-headed households enjoy significantly higher herd growth rates, which may partly capture household composition effects (with male-headed households having more men able to herd, holding labor availability constant). There exist statistically significant, albeit diminishing, marginal returns to herding experience. And there are marginally significant fixed effects associated with location and year (for 2001-2, the year of recovery after the severe 1999-2000 drought), the latter result reinforcing our earlier finding about state-dependent growth.

Using the predicted value of each herder's estimated technical inefficiency, we then divide our sample into two sub-samples: lower ability (those in the 4th quartile of the inefficiency estimates, above 15.38) and a complementary category of higher ability herders. The distribution of the inefficiency estimates (with cattle as the units) is presented in figure 7,²¹ allowing a visual analysis of the diversity within each sub-sample. The observations are concentrated within a limited range of inefficiency estimates, suggesting that there may be little value to further subdivision of the sample.²²

For each of these classes we re-estimated equation (2), obtaining estimates of the parametric models that relate expected and initial herd size²³ for each sub-sample. After

this variable is statistically insignificantly different from zero, when we do not control for this effect, the estimated coefficients on lagged herd size and its various interactions become far more imprecise.

²¹ Estimated using the Epanechnikov kernel, with a bandwidth of 0.24697.

²² In an earlier version of this paper, we did experiment with splitting the higher ability herders into two categories, those of highest ability (the 1st quartile of the inefficiency distribution) and a residual medium ability class (the 2nd and 3rd quartiles). The qualitative results are similar, so we present the simpler approach.

²³ These 8 parametric models (4 states of nature x 2 ability classes) are qualitatively similar to the ones presented in Table 1. To conserve space, we omit them here but they are available from the authors upon request.

calibration of these models we performed the same simulations as above. Figure 8 shows the mean of 10-year-ahead herd size obtained for 500 replicates with initial herd sizes between 1 and 60 for each ability class. The results are easily summarized. Although those in the lowest ability quartile exhibit S-shaped expected herd dynamics, these lie everywhere beneath the dynamic equilibrium line (the solid 45-degree line in figure 6). Thus, low ability herders are expected to converge towards the low level dynamic asset equilibrium of 1 or 2 head of cattle, just as Lybbert et al. (2004) found unconditional on ability. Higher ability herders likewise exhibit S-shaped expected herd dynamics. However, they face multiple dynamic equilibria, with a threshold (i.e., unstable dynamic equilibrium) at 12-17 cattle, similar to the threshold Lybbert et al. (2004) estimated in the herd history data. Notice also that, when we allow for different growth paths conditional on ability, we get much more precise estimates of the dynamics of this system. In particular, both confidence bands cross the equilibrium line in three intervals, two of which represent stable equilibria. The implication, reflected in figure 8, is that S-shaped herd dynamics characteristic of a poverty trap are not followed by all herders. In particular, low ability herders face a unique dynamic equilibrium at lower levels of welfare, giving rise to a different sort of poverty trap than that faced by herders with higher ability, who expect to accumulate wealth so long as they start with an adequate herd size. Figure 9 presents the limiting distributions of the wealth transitions for the two ability groups, reinforcing this point. Herders of higher ability enjoy a probability of holding herds above 55 cattle that is almost 5 times that for herders of lower ability.

These results clearly raise important practical questions with respect to any asset redistribution or transfer policy, as ability is not easily established, at least not by

outsiders such as the governmental and nongovernmental agencies that typically provide transfers and public safety net programs.²⁴ Because of these critical policy implications, we sought to confirm this last result in the herd history data used by Lybbert et al. (2004). As before, we do that in two steps. First, we estimate a stochastic growth frontier, following equation (3), to obtain estimates of herder-specific, time-invariant inefficiency relative to the estimated growth frontier, and interpret these inefficiency estimates as a measurement of unobserved ability. Given the longer panel, here we use decadal (ten year) transitions, rather than the annual transitions estimated in the more detailed PARIMA data. But the limited variables in this dataset restrict the controls we can include to site fixed effects and the number, in the previous decade, of years of bad rainfall and of good rainfall. As a consequence the interpretation of estimated inefficiency as ability is considerably less clear than in our previous results. Nevertheless, as a check on the robustness of the previous result, we think it is useful. Finally, because we are interested in comparing our results with the ones from the previous section, we restrict the estimation of this efficiency frontier to herd sizes within the same range as found in the PARIMA data, below 100 cattle.²⁵ Table 5 presents the estimation results.

The first observation concerns the statistical insignificance of the explanatory variables. The effect of past herd sizes (here, with a lag of 10 years) is better expressed through a cubic function and we cannot find evidence of a threshold at an initial herd size of 15 cattle, as we found in the PARIMA data analyzed above. These results can be

²⁴ Santos and Barrett (2006) explore the effects of ability and multiple equilibria on private, interhousehold transfers among these pastoralist households.

²⁵ The smaller maximum herd sizes in the PARIMA data than in the Desta/Lybbert data reflect declining median herd sizes as well, reflecting what most observers perceive as deepening poverty in the region.

explained both by the lack of detailed information on other covariates available in the PARIMA data, the much longer lag being explained and the overall differences between the two samples (for example, with respect to average herd size: 68.5 cattle in this sample versus 14.7 in the PARIMA data). As a consequence, not only are the inefficiency terms clearly different, they also explain a much share of total variation ($r^2=0.869$ versus 0.229 in Table 3). Figure 10 graphs the empirical density function.²⁶

With these estimates of herder-specific ability, we now explore the possibility of heterogeneous wealth dynamics within this sample using regression trees. This approach was used by Durlauf and Johnson (1995) and more recently by Tan (2005) to study economic growth in national-level data. Regression trees is a non-parametric technique introduced by Breiman et al. (1984) that allows the identification of an *a priori* unknown number of sample splits in order to maximize the fit of piecewise linear estimate of a regression function.²⁷ At each split, the estimator defines increasingly homogeneous subsets, without the need to determine exogenously the threshold variables and values that mark such divisions. Given the lack of theory on how to select such variables, this approach has the double advantage of eliminating much of the arbitrariness in the analysis and of providing results that are structurally interpretable, in the sense that they reveal the relative importance of particular determinants of the relation being explained. Although the results have been shown to be consistent (Breiman et al., 1984), the limitation remains that there is no asymptotic theory to test the statistical significance of the number of splits identified.²⁸ In what follows we'll use the *Generalized, Unbiased*

²⁶ Estimated using the Epanechnikov kernel, with a bandwidth of 6.9621.

²⁷ A very brief introduction to regression trees can also be found in Hardle (1990, chapter 10.1).

²⁸ Other approaches, such as the use of mixture models (Bloom, Canning and Sevilla 2000) can, in principle, overcome such problem but, given their computational cost, usually at the cost of reducing the

Interaction Detection and Estimation (GUIDE) algorithm, explained briefly in the Appendix and at length in Loh (2002).

The result of this procedure is the regression tree shown in figure 11. Empty circles indicate the splitting criteria while numbered circles represent terminal nodes that contain different subsamples. At each splitting point, the tree indicates the threshold variable and its value. Observations with a value smaller than the threshold value follow the left branch from the node; those with a greater value follow the right branch. Consistent with our findings to this point, the first splitting variable is herder ability, which divides the sample into 164 observations on 24 lower ability herders (a much larger subsample than the lower quartile we arbitrarily imposed earlier) and 70 observations on 21 higher ability herders. Within the subsample of lower ability herders, there does not appear to be any threshold in the herd growth function, consistent with our earlier findings using other data from this region. Within the subsample of higher ability herders, however, a further split occurs, at the relatively high herd size of 66 head of cattle. The sample splitting generated by the regression trees method thus reinforces the finding of a unique equilibrium for lower ability herders and multiple equilibria for the rest.

Our estimates of the herd growth models associated with each terminal node appear in Table 6 and are graphed in figure 12.²⁹ Expected herd dynamics appear highly nonlinear in each regime. For the lower ability herders, however, the unique dynamic

number of admissible splits. Note also that the validity of the theory underlying the identification of thresholds through sample splitting proposed in Hansen (2000) is unclear when we consider more than one split of the original sample, as noticed by the author (p.588).

²⁹ The (perhaps counter-intuitive) lack of smoothness of these growth paths is a general result of the regression trees approach, given that splitting the data implicitly assumes that small changes in one variable lead to significant changes in behavior.

equilibrium occurs at a herd size of zero, qualitatively consistent with the earlier evidence of expected collapse into destitution. Interpretation of the higher ability herders' expected wealth dynamics is somewhat complicated by inevitable extreme behaviors in the tails of each subsample, due to the low-order polynomial, parametric model being fitted. But this too is qualitatively quite similar to our previous result. In particular, there appear multiple stable equilibria, in this case at 18-20 animals and around the sample splitting point of 66 head for those within the range of herd sizes comparable to our earlier results.

5. Expected growth and inequality among the Borana

We now apply this simulation approach to analyze the expected evolution of wealth and inequality in our sample of respondents. We use the same approach as above on the subsample of 97 households that had cattle in 2003.³⁰ Table 7 presents the results for expected average herd size 10 years ahead and for expected inequality, based on 500 runs of our simulation procedure, first when we disregard the effect of herder ability (column b), then when we incorporate it (column c).

The results are simple to interpret. When we take into consideration the role individual heterogeneity plays in shaping wealth dynamics, we should expect both an increase in average herd size and a large increase in inequality over time, as low ability herders collapse into destitution. If we simulate the evolution of the wealth of this population with a simpler approach that neglects such differences, then still expect an

³⁰ From our sample of 120 respondents, 5 were not interviewed in 2003 and 18 had no cattle. Given that we did not elicit the expectations about herd evolution for this situation and that, to the best of our knowledge there are no reliable estimates of the rate of re-entry into pastoralism for herders who lose all their cattle, we dropped them from the simulation. Among those with no cattle in 2003, 5 households (or 27%) were classified as being of low ability, 11 (61%) as being of medium ability and the other 2 (11%) as being of high ability.

increase in inequality (although somewhat smaller), but with a decrease in average wealth.

Finally, we explore the effectiveness of herd restocking in this system, as this is perhaps the most common form of post-drought assistance provided to pastoralists by donors and governments in the region. We simulate the effect of three different scenarios. In Scenario 1, all herds below 5 cattle (the Boran-defined poverty line) are given animals to boost their herd to 5 head. In aggregate, that corresponds to a transfer of 36 cattle to 17 beneficiaries. In Scenario 2, we simulate the effects of transferring (approximately) the same number of cattle – so as to compare mechanisms under a constant budget – but now targeted not to the poorest first but rather in order to maximize expected herd growth from the transfer, assuming there exists no effective mechanism to elicit herder ability. Scenario 2 involves a fictive transfer of 35 cattle to 13 beneficiaries. In Scenario 3, we assume one can accurately identify herder by ability group and, as with Scenario 2, again target transfers so as to maximize asset growth. Scenario 3 involves transfers of 37 cattle to 16 high ability herders.

The main difference between these scenarios is evident in Figure 13, where we draw the expected herd growth associated with the transfer of 1 cattle. Given expected herd dynamics over the decade following the hypothesized transfer, the transfer is expected to generate herd growth, net of the 1 cattle transfer, only for recipients with ex ante herd size between 7 and 22 head. Those with the smallest (or largest) herds are expected to lose some of their post-transfer herd over the ensuing decade, signaling negative medium-to-long term growth returns on livestock transfers to the poorest (or wealthiest) herders. The expected herd gain is maximized for an ex ante herd size of 13

cattle, a significantly larger herd than is typical of restocking program participants, since such interventions are typically targeted following some wealth-sensitive process, like Scenario 1.

Table 8 presents the results of a comparison among these three different scenarios for targeting herd restocking transfers. As one would expect based on the growth dynamics in the system, restocking targeted to the lower levels of wealth (specifically, those below 5 cattle) fails to promote growth among the poor. After 10 years, beneficiaries enjoy an expected gain of 1.35 cattle, but from an average transfer of 2.12 cattle. This implies a -4.4% compound annual return on investment in transfer resources, given expected herd losses below the critical herd size threshold. The growth-promoting impacts of herd restocking become more satisfactory in the other two scenarios. Under scenario 2, the average net returns to this policy after 10 years are 17% (1.6% annually). These more than double, to 37% (3.3% annually), under scenario 3, showing that the growth payoff to identification of a reliable mechanism for identifying herding ability is potentially considerable since ability seems to matter a great deal to wealth dynamics in this system.

6. Conclusions

Using unique data on household-level expectations of herd growth, collected through innovative empirical methods for eliciting subjective herd growth distributions, we find that southern Ethiopian pastoralists appear to understand the nonstationary herd dynamics that long-term herd history data suggest characterize their system, corroborating Lybbert et al.'s (2004) results using different data and methods. A poverty

trap indeed seems to exist. Moreover, their responses enable us to unpack the herd history data, revealing that multiple dynamic equilibria arise purely due to adverse shocks associated with low rainfall years and for pastoralists of higher herding ability. Lower ability herders appear to converge towards a unique, low-level equilibrium herd size. Thus, the data suggest that even among a seemingly homogeneous population in an ethnically uniform region offering effectively only one livelihood option – livestock herding – there exist complex wealth dynamics characterized by distinct convergence clubs defined by individual ability and multiple dynamic equilibria for only a subset of those clubs.

These findings carry two very general policy consequences. First, the need for interventions to lift people out of – or prevent their collapse into – poverty traps, seems to depend on the nature of the adverse shocks, in particular whether their severity and frequency is such that growth under favorable states of nature is often and sharply reversed, making accumulation below a critical threshold unlikely, albeit not impossible. Risk mitigation to limit the frequency or magnitude of shocks may be as or more valuable than transfers to facilitate growth among the poorest. Second, the appropriate means of social protection in this stochastic environment depends very much on individual characteristics, perhaps including difficult-to-observe characteristics such as ability. Identifying ability may be operationally difficult, but failure to take such characteristics into account may lead to ill-conceived efforts and wasted scarce resources.

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Figure 1: Herd dynamics, based on respondent subjective expectations (all cases)

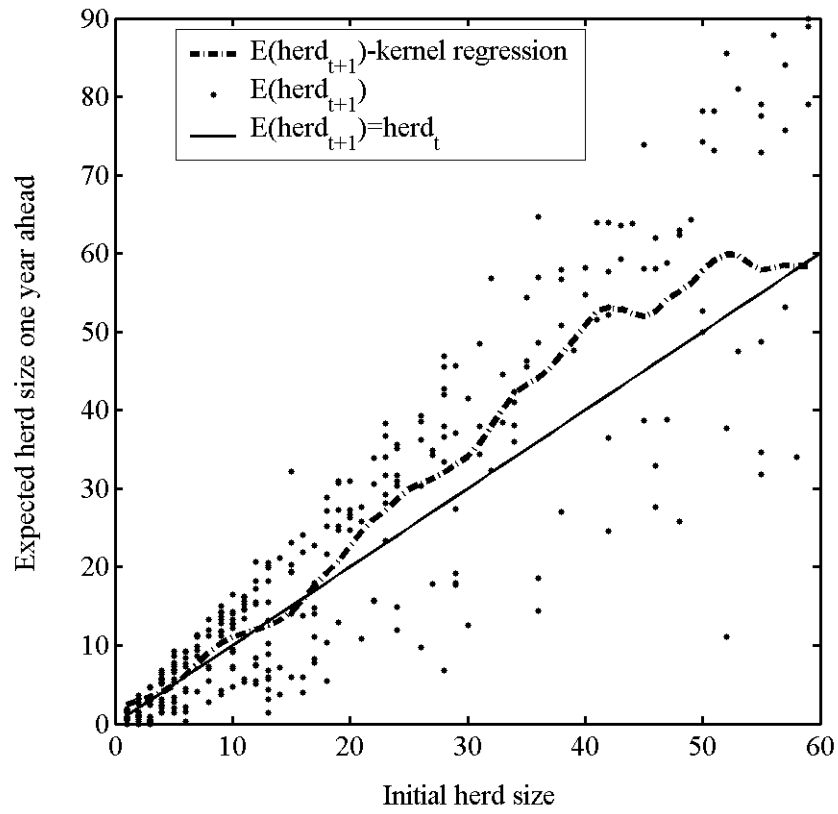
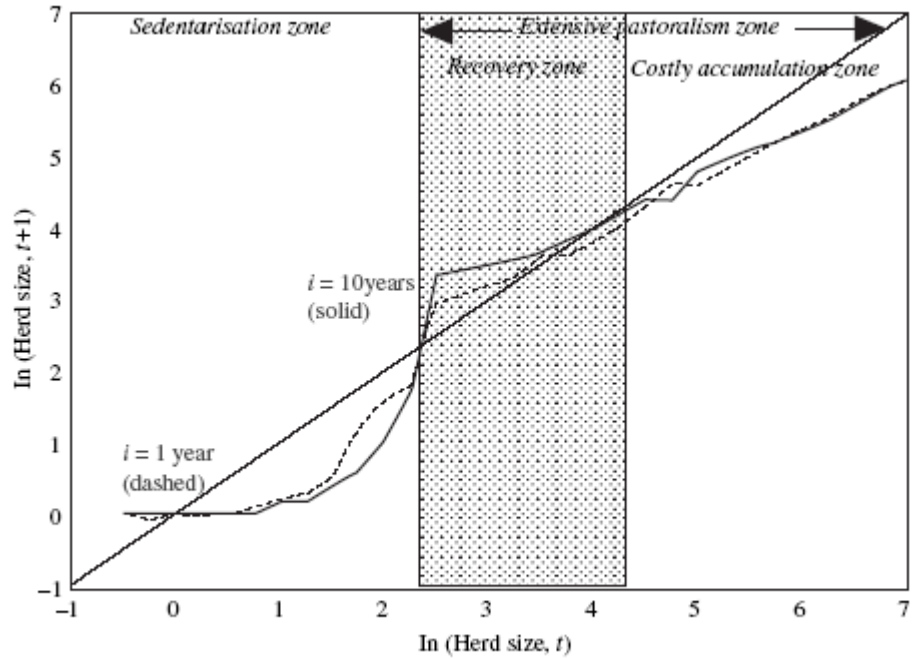


Figure 2: Herd dynamics in southern Ethiopia, based on herd history data

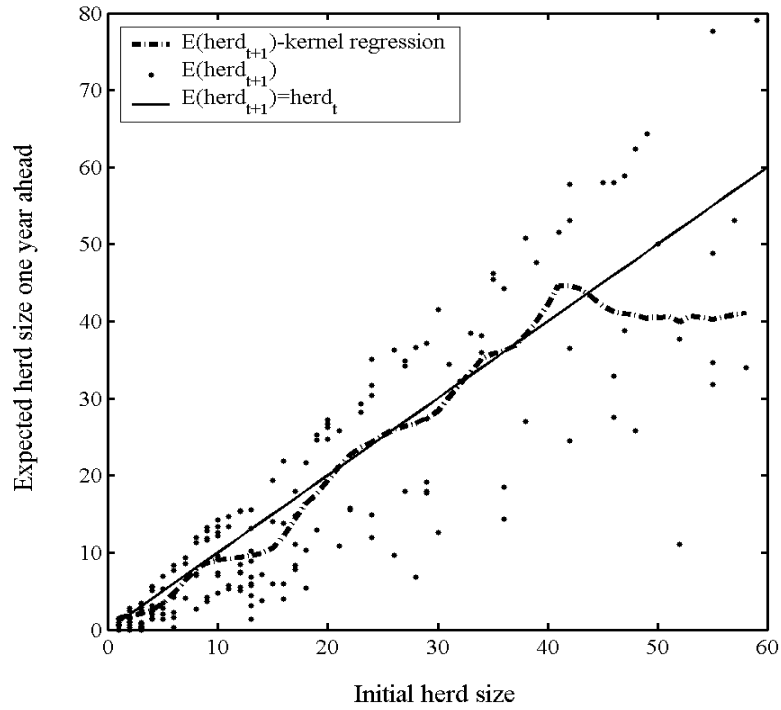
(reprinted from Lybbert et al. (2004))



Nadaraya-Watson estimates using Epanechnikov kernel with bandwidth ($h = 1.5$)

Figure 3: Expected herd dynamics conditional on rainfall conditions

a) Bad rainfall conditions



b) Good/normal rainfall conditions

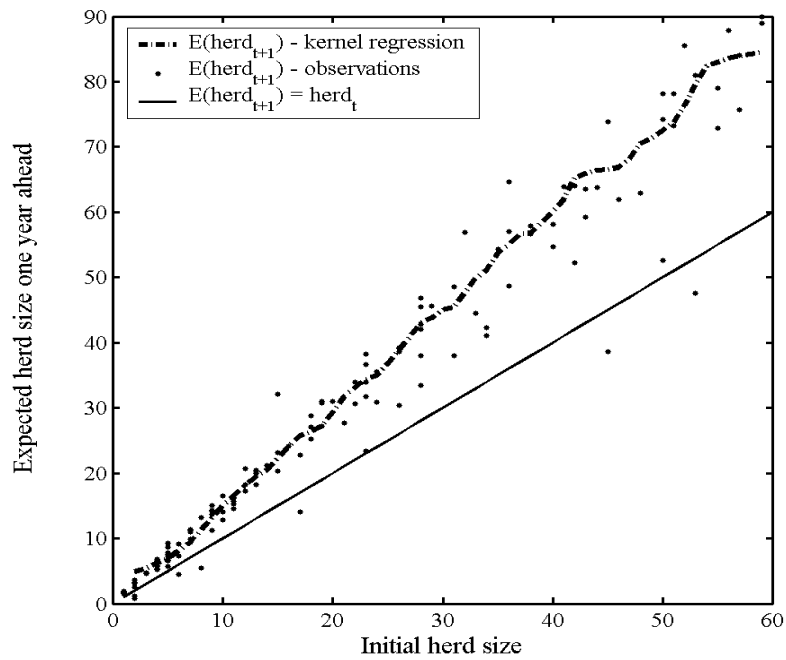
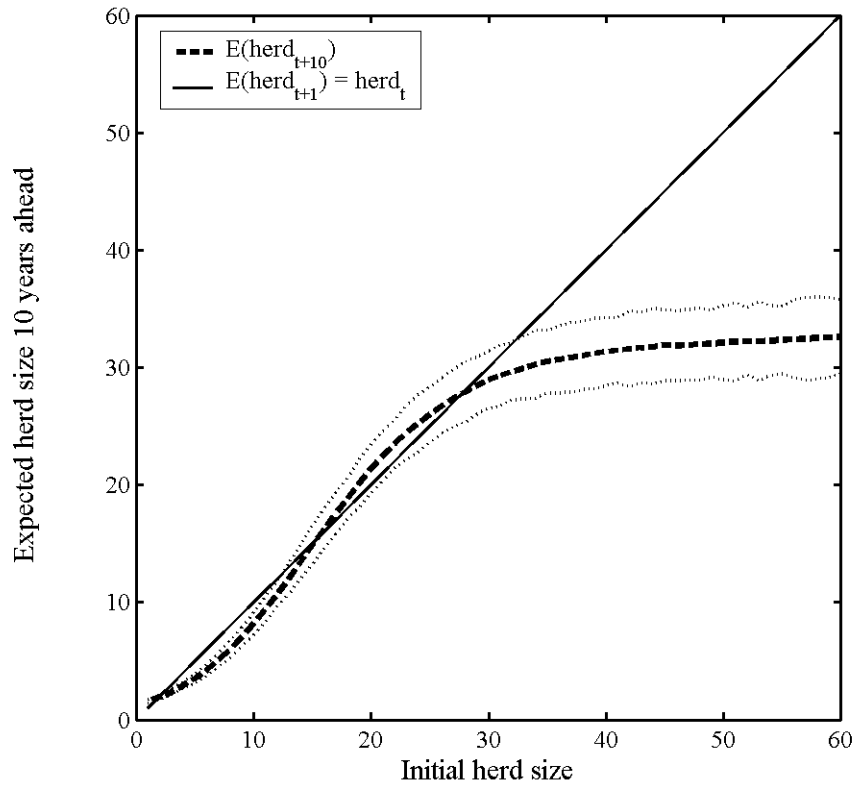


Figure 4: Simulation method schematic

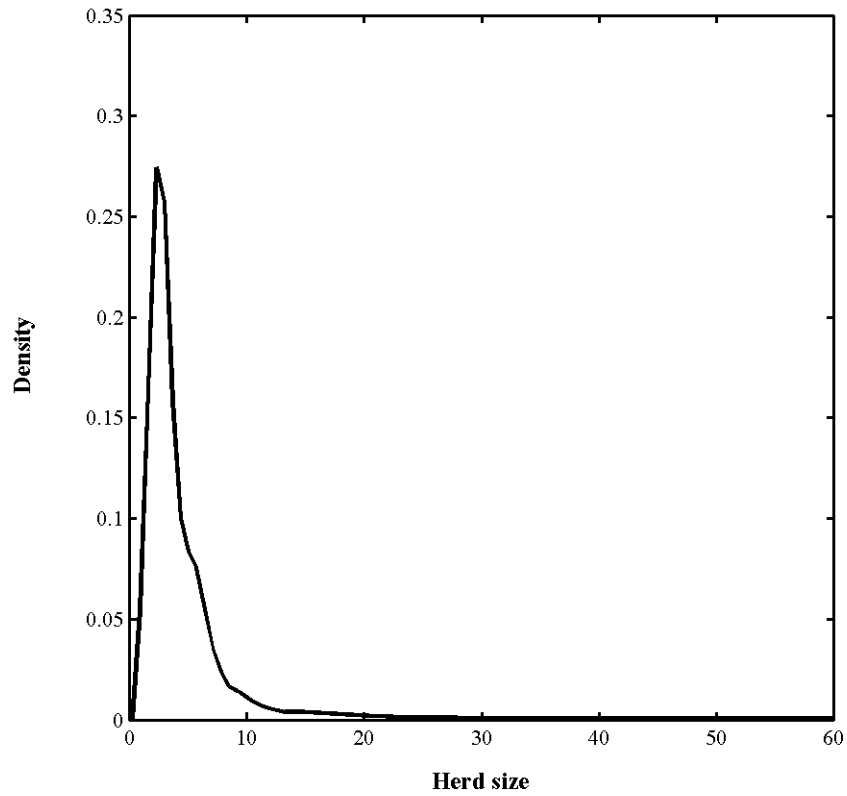
Time Period	t-1		T		t+1
	herd t	→	Rainfall draw		
			↓ call appropriate growth model		
			[herd1= f (herd0 rainfall)]		
			predict next period's herd ↓		
			herd t+1	→	repeat as in period t

Figure 5: Simulated expected herd dynamics based on estimated state-conditional dynamics and stochastic rainfall



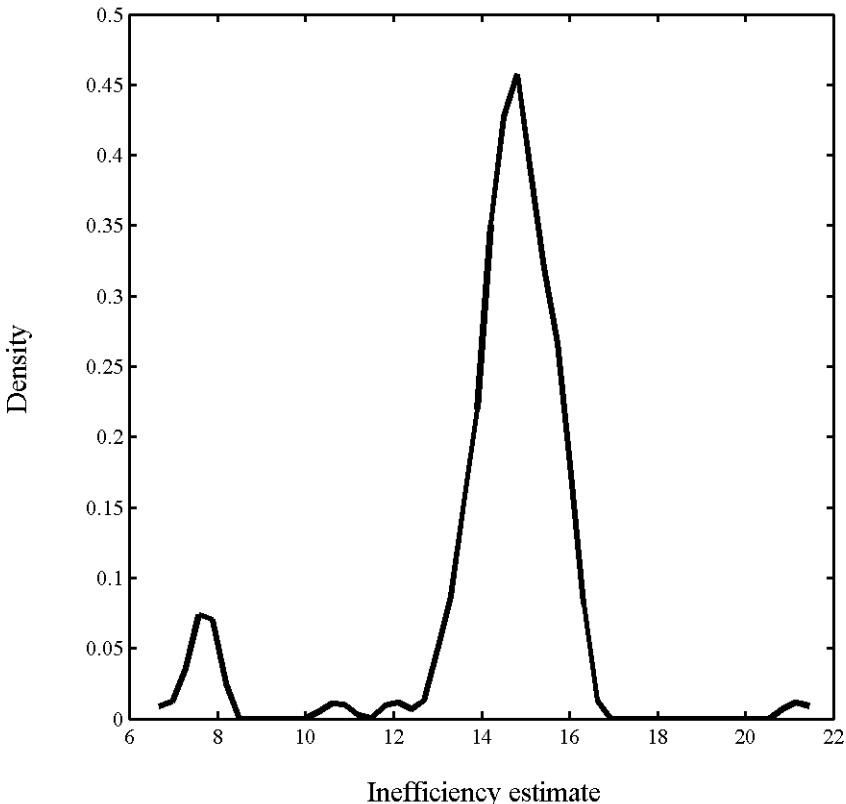
Note: Dotted lines are bootstrapped confidence bands using 200 replicates.

Figure 6: Limiting distribution



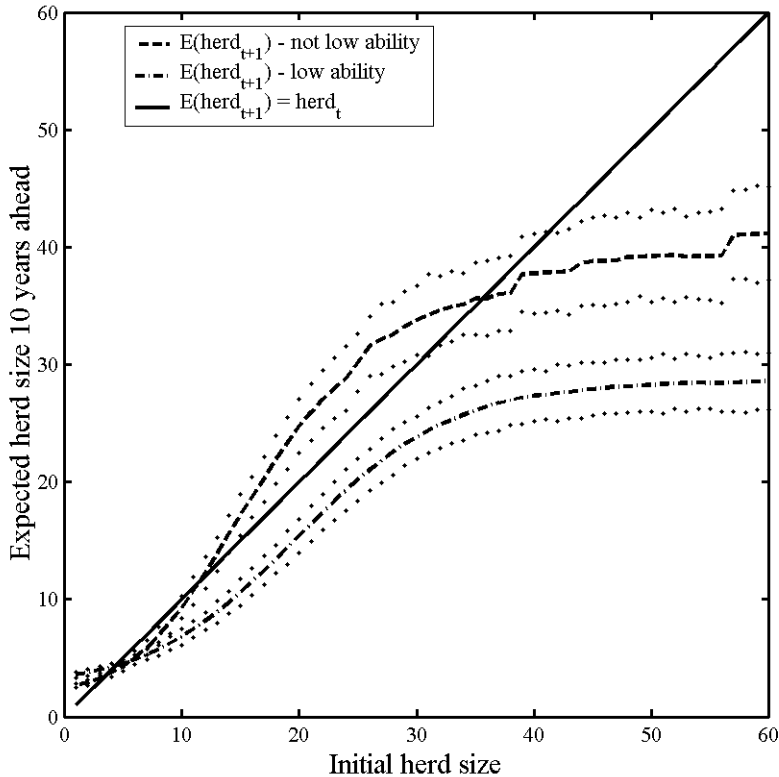
Note: Density estimates using a Gaussian kernel with variable bandwidth (Fox 1990). The underlying Markov matrix is a 12x12 matrix of equally spaced herd sizes, with the last category representing the interval $[55, +\infty)$.

Figure 7: Empirical density function of inefficiency estimates



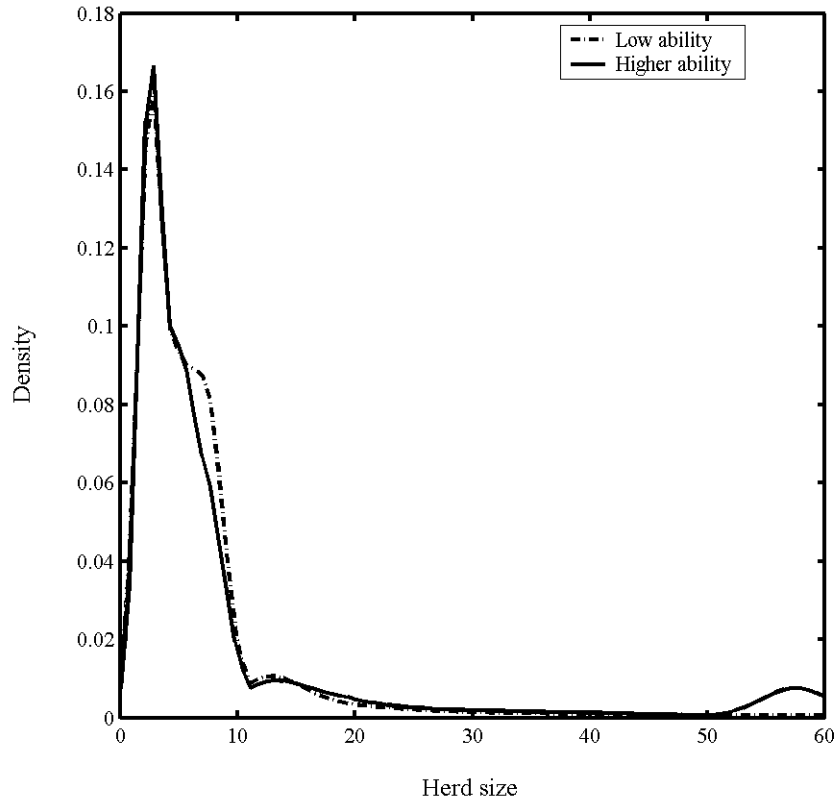
Empirical density estimates obtained using an Epanechnikov kernel with bandwidth 0.2469 selected using Silverman’s rule of thumb.

Figure 8: Expected herd dynamics: the effects of herder ability



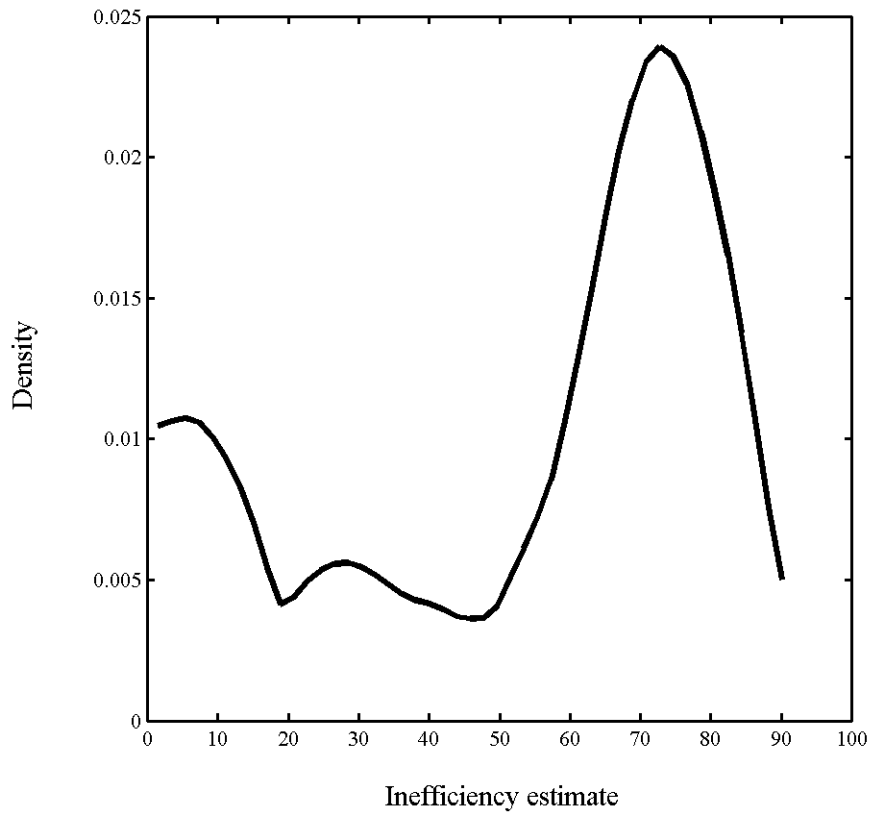
Note: dotted lines are bootstrapped confidence bands using 200 replicates.

Figure 9: Limiting distribution – the effect of ability



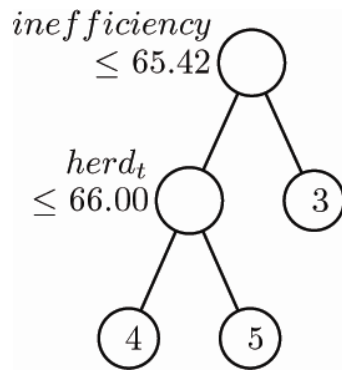
Note: Density estimates using a Gaussian kernel with variable bandwidth (Fox 1990). The underlying Markov matrix is a 12x12 matrix of equally spaced herd sizes, with the last category representing the interval $[55, +\infty)$.

Figure 10: Empirical density function of inefficiency estimates.



Empirical density estimates obtained using an Epanechnikov kernel with bandwidth 6.962 selected using Silverman's rule of thumb

Figure 11: Real herd dynamics: regression tree due to ability and initial herd size



Piecewise-multiple linear least square GUIDE model.
At each intermediate node, a case goes to the left
node if and only if the condition is satisfied.

Figure 12: Predicted herd dynamics, conditional on ability and initial herd size

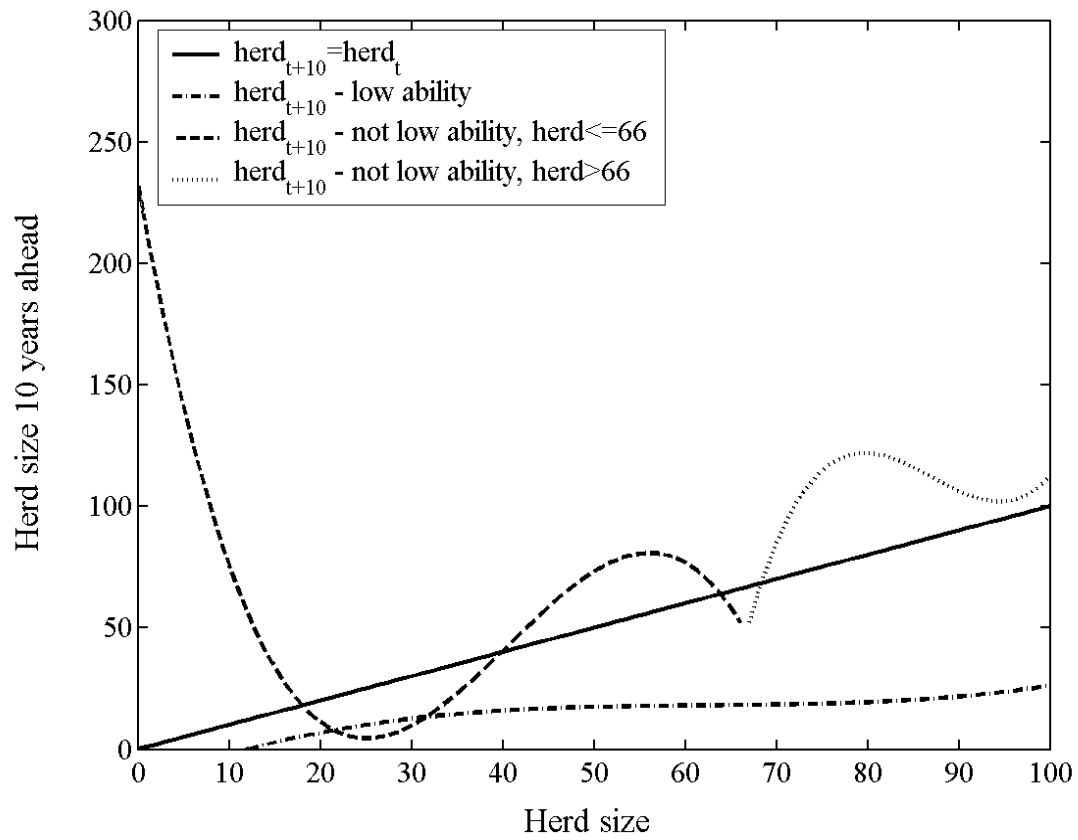


Figure 13: Expected gains from the transfer of 1 cattle

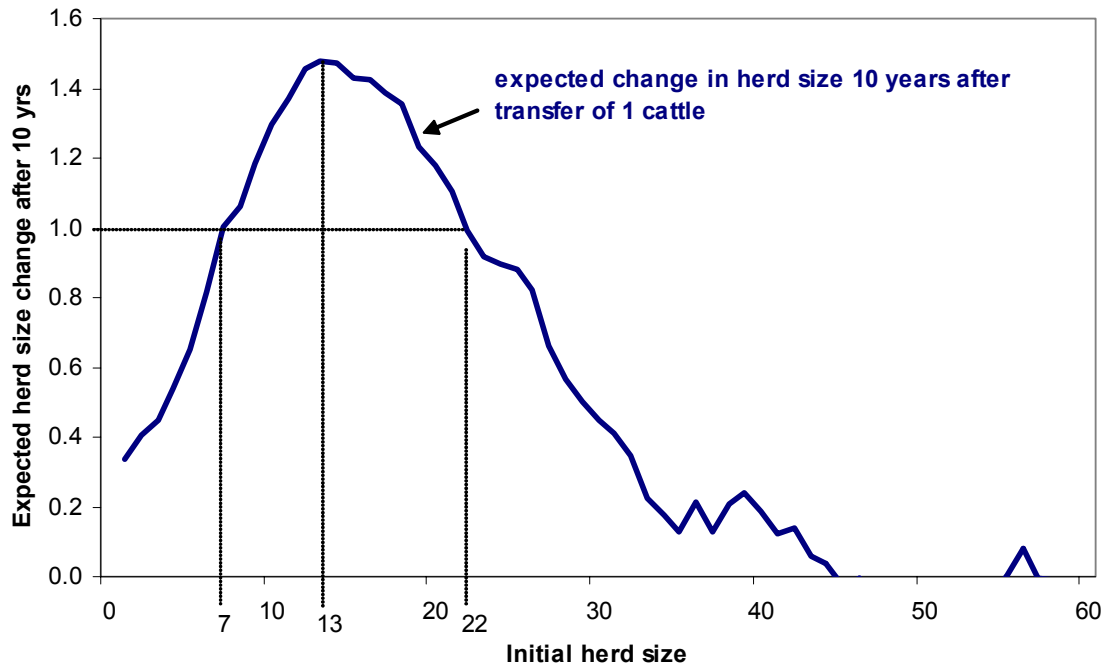


Table 1: Fixed Effects Estimates of Expected Herd Dynamics Conditional on Rainfall

Rainfall	Very good	Good/normal	Bad	Drought
<i>herd0</i>	1.293	1.477	0.528	0.246
	[0.000]	[0.019]	[0.224]	[0.214]
<i>herd0</i> ²			0.026	0.009
			[0.010]	[0.010]
<i>herd0</i> ³			-0.00039	-0.00017
			[0.0001]	[0.0001]
Constant	0.897	0.179	0.513	-0.575
	[0.448]	[0.415]	[1.185]	[1.083]
r ²	0.986	0.984	0.792	0.589
Number of Observations	61	96	192	61

Note: Robust p-values within brackets.

Table 2: Herd Size Transition Matrix (10 year period)

(figures in cells reflect estimated probabilities)

$h_t \backslash h_{t+10}$	0-4	5-14	15-39	> 40
1-4	0.879	0.113	0.009	0.000
5-14	0.575	0.262	0.133	0.030
15-39	0.204	0.280	0.255	0.261
40-60	0.136	0.230	0.291	0.343

Table 3: Stochastic Parametric Herd Growth Frontier Estimates

	Point Estimate [p-value]
herd size at t-1*above threshold	1.022
	[0.000]
herd size at t-1 squared * above threshold	-0.000
	[0.689]
herd size at t-1* below threshold	0.890
	[0.004]
herd size at t-1 squared * below threshold	-0.009
	[0.681]
no cattle at t-1	-1.126
	[0.366]
labor * above threshold	-0.089
	[0.611]
labor * below threshold	0.099
	[0.427]
Land	0.022
	[0.885]
sex	1.333
	[0.057]
Experience	0.137
	[0.052]
experience squared	-0.002
	[0.174]
Migrant	-0.605
	[0.544]
2000-01	-0.740
	[0.164]
2001-02	1.553
	[0.003]
Dida Hara	1.870
	[0.092]
Qorate	0.026
	[0.983]
Wachille	0.827
	[0.465]
Constant	13.012
	[0.947]
μ	14.671
σ^2_{μ}	4.331
r^2	0.230
H_0 : cattle above threshold = cattle below threshold (prob > F)	0.053

Note: robust p-values within brackets.

Table 4: Explanatory variables: definition and descriptive statistics

Variable	Definition	Mean (standard deviation)
herd size at t-1*above threshold	Herd size in the previous period if greater than 15, 0 otherwise	3.95 (3.99)
herd size at t-1* below threshold	Herd size in the previous period if smaller or equal to 15, 0 otherwise	4.17 (12.08)
no cattle at t-1	Dummy variable, equal to 1 if the respondent has no cattle in the previous period, 0 otherwise	0.185 (0.389)
labor * above threshold	Family size, if herd size in the previous period is greater than 15, 0 otherwise	3.44 (3.38)
labor * below threshold	Family size, if herd size in the previous period is smaller or equal than 15, 0 otherwise	0.87 (2.67)
Land	Land cropped in June 2000	1.12 (2.25)
sex	Dummy variable, equal to 1 if the respondent is male	0.639 (481)
Experience	Number of years between start of herd management	20.26 (14.07)
Migrant	Dummy variable, equal to 1 if the respondent migrated to the are where currently lived	0.210 (0.408)
Dida Hara	Dummy variable, equal to 1 if the respondent lives in Dida Hara	0.25 (0.43)
Qorate	Dummy variable, equal to 1 if the respondent lives in Qorate	0.25 (0.43)
Wachille	Dummy variable, equal to 1 if the respondent lives in Wachille	0.25 (0.43)

Table 5: Stochastic Parametric Herd Growth Frontier Estimates

Dependent variable: Herd _t	Point estimate [p-value]
Herd _{t-10}	0.141 [0.779]
Herd _{t-10} ²	0.001 [0.914]
Herd _{t-10} ³	-0.000 [0.985]
Good rainfall	0.005 [0.997]
Bad rainfall	-1.907 [0.178]
Mega	0.613 [0.963]
Arero	-5.009 [0.713]
Negelle	-13.120 [0.294]
Constant	206.316 [0.976]
μ	68.511
σ^2_{μ}	795.561
r^2	0.869

Note: robust p-values within brackets.

Table 6: Herd dynamics

Terminal node	Inefficiency > 65.42	Inefficiency \leq 65.42 & Herd _{t-10} \leq 66	Inefficiency \leq 65.42 & Herd _{t-10} > 66
Variable	Point estimate [p-value]	Point estimate [p-value]	Point estimate [p-value]
Herd _{t-10}	2.162 [0.000]	-6.739 [0.007]	268.360 [0.020]
Herd _{t-10} ²	-0.0043 [0.001]	0.246 [0.002]	-3.074 [0.027]
Herd _{t-10} ³	0.00027 [0.000]	-0.00231 [0.001]	0.0116 [0.036]
Yabello	1.263 [0.573]	0.145 [0.136]	53.630 [0.000]
Mega	4.495 [0.084]	-4.217 [0.570]	48.427 [0.000]
Arero	1.388 [0.584]	-1.468 [0.016]	
Low rain	2.036 [0.007]	2.607 [0.208]	-18.317 [0.002]
High rain	0.741 [0.278]	-1.337 [0.534]	-20.183 [0.497]
Constant	-1.905 [0.000]	74.395 [0.014]	-7604.675 [0.016]
Number of observations in subsample	164	41	29
r ²	0.28	0.76	0.71

Table 7: Expected evolution of wealth and inequality among the Borana.

	2003 (a)	2013 (disregarding ability) (b)	2013 (considering ability) (c)
Average herd size	12.76 (1.49)	10.47 (3.59)	14.59 (8.11)
Gini coefficient on herd size	0.46 (0.05)	0.66 (0.04)	0.71 (0.07)

Note: values in column (a) reflect the situation among the 97 respondents in the PARIMA sample that had cattle in 2003. Values in columns (b) and (c) are the expected values of the statistics for 500 runs of our simulation procedure. Values within parentheses are standard errors. The standard deviation for the Gini coefficient was computed using the algorithm described in Karagiannis and Kovacevic (2000).

Table 8: Expected effects of restocking under different targeting assumptions

Scenario	Number	Average Transfer	Average herd size (2003)	Expected herd size (2013)		Expected gains from transfer
				w/ transfer	w/out transfer	
1 Beneficiaries	17	2.12	2.88	4.06	2.71	1.35
Non- Beneficiaries	80	0	14.86	12.05	12.05	-
2 Beneficiaries	13	2.69	12.54	14.63	11.48	3.15
Non- Beneficiaries	84	0	12.80	10.25	10.25	-
3 Beneficiaries	16	2.31	11.69	18.76	13.62	5.14
Non- Beneficiaries	81	0	12.97	16.64	16.64	-

Appendix: Regression trees analysis

This Appendix describes the construction of a regression tree using **Generalized, Unbiased, Interaction Detection and Estimation (GUIDE)**. Loh (2002) is the central reference, while Loh (2005) explains how to use the program, which is freely downloadable from www.stat.wisc.edu/~loh/, and how to interpret the output.

We start by considering four categories of variables, as a function of their type (numerical(N)/ categorical(C)) and their role in the model (fit the model(F)/ split the tree(S)/ both):

	Fit	Split	Fit + Split
Numerical	F	S	N
Categorical	F *	C	N *

* in these cases, the variable is converted to a dummy variable. We use the same designation regardless of the role.

The algorithm proceeds in three steps: 1) choice of the splitting variable at each node of the tree; 2) choice of the splitting value and finally, 3) cost-complexity pruning. Steps 1) and 2) construct two mutually exclusive subsets at each node, starting with the set of all observations and stopping when the number of observations in the subsets falls below a predetermined (chosen) value. To avoid over-fitting the data, the tree is pruned back using a cost-complexity algorithm.

The choice of the split variable proceeds as follows:

- 1) obtain the residuals from the regression on the N and F variables;
- 2) for each numerical variables used to split the sample (either S or N), divide the data into 4 groups at the sample quartiles; construct a 2x4 contingency table with the signs of the residuals (positive/ non-positive) as rows and the groups as columns; count the number of observations in each cell and compute the χ^2 statistic and its p-value from the χ^2_3 distribution;

- 3) do the same for each categorical variable used to split the sample (either C or N), taking the categories of the variable as the columns; omit those columns with zero column totals;
- 4) to detect interactions:
 - 4.1) between pairs of variables, divide the space formed by them into 4 quadrants by splitting each in two at the sample median; construct a 2x4 contingency table (with residuals as rows and each quadrant as columns); compute the χ^2 statistic and its p-value;
 - 4.2) do the same for each S variable;
 - 4.3) use the value pairs of the C variables to divide the sample space; construct a 2 x (c1 x c2) contingency table, where c1 and c2 are the number of unique values of each variable; compute the χ^2 statistic and its p-value, omitting those columns with zero column totals;
 - 4.4) compute the χ^2 statistic and its p-value for each pair (N, C) from a contingency table with 2 x (2 x c1) dimensions, omitting those columns with zero column totals;
 - 4.5) do the same for each pair (S, C);
 - 4.6) do the same for each pair (S, N), following 4.4);
- 5) if the smallest p-value comes from one of the sets generated by steps 2) or 3), the associated variable is selected to split the node;
- 6) if the smallest p-value comes from one of the sets generated by step 4), then use the following rules to select which, from among the interaction variables, is the splitting variable:
 - 6.1) if only one of these variables is a N-variable, choose the other one;
 - 6.2) if neither is a N-variable, choose the one with the smallest p-value, as computed from step 3);
 - 6.3) if both are N-variables, split the node along the sample mean of each variable and choose the variable whose split yields the smaller total SSE.

After this step, the split value for that variable has to be determined. This is done using the next algorithm:

1) define the partitions $P_1(v)$ and $P_2(v)$ as:

$$P_1(v) = \{(y, X) \mid x_j \leq v\}$$

$$P_2(v) = \{(y, X) \mid x_j > v\}$$

where $x_j \in X_j$ and X_j is the chosen split variable;

2) regress y on X separately for each partition and obtain the residuals of these regressions (r_1 and r_2 , respectively);

3) choose v to be the value of the split variable that minimizes the sum of squared residuals:

$$1/n_1 * r_1^2 + 1/n_2 * r_2^2.$$

where n_1 and n_2 are the number of observations in each partition.

Finally, once the most extensive tree is constructed, the algorithm “prunes” it to avoid over-fitting the data. This is done using cost-complexity pruning, where a penalty is put on overly complex trees: formally, the cost complexity criterion is expressed by

$$(A.1) \quad C_\alpha(T_b) = \sum_{n=1 \dots b} \sum_{(x_i, y_i) \in n} (y_i - \beta_n x_i)^2 + \alpha * b$$

where α is the penalty parameter ($0 \leq \alpha \leq \infty$), T_b represents a tree with b nodes. The objective of the algorithm is to identify the tree that minimizes C_α . It proceeds in two steps: the construction of the optimal tree for each value of α (denote it by $T^*(\alpha)$) and the choice of the optimal α (denote it by α^*). Denote by T_0 the tree originated when splits were costless (that is, $\alpha = 0$).

- 1) Start with T_0 and increase α .
- 2) Remove any terminal splits in T_0 whose elimination reduces the value of equation (A1), producing a new tree. This is done by merging the observations in these terminal nodes in a new terminal node.
- 3) Increase α by a chosen increment.
- 4) Repeat Steps 2) and 3) until the nodes of tree have a unique element (by analogy with our previous notation, denote the resulting tree by T_∞).
- 5) For each $T^*(\alpha)$, produce a V -fold cross validated estimate of the squared sum of residuals (SSR) in equation (A1).

6) Choose $T^*(\alpha)$ that minimizes the SSR.

Breiman et al. (1984) show that each of the trees in the (finite) sequence between T_0 and T_∞ is unique and it must contain $T^*(\alpha^*)$. The concept of V-fold cross-validation is explained in detail in Hastie et al. (2001, section 7.10).