

Abstract

In this thesis, I study the hand-to-mouth behavior of the poor that originates from inattentive savings behavior and leads to a poverty trap. I assume that in the rational inattention model people acquire costly information about stochastic permanent income and choose a savings plan. I hypothesize that in this context high information costs and low income variance may encourage poor agents to choose a rigid savings plan below an optimal level, persistently undersave, and get stuck in a poverty trap. I construct and solve the two-period rational inattention model of savings decisions. The results show that a poor agent chooses a rigid savings plan below an optimal level when information costs are high and income variance is low. I discuss avenues for future research that are based on solving an infinite-horizon model with rationally inattentive agents, provide the conditions under which a poverty trap occurs, and test the model on consumption-savings data.

Keywords: information costs, hand-to-mouth behavior, poverty trap, savings plan