CIE Economics A-level

Topic 3: Government Microeconomic Intervention

b) Equity and policies towards income and wealth redistribution

Notes

In the absence of government intervention, the market mechanism is likely to result in a very unequal and inequitable distribution of income and wealth.

An unequal distribution can lead to negative externalities, such as social unrest. In a market economy, an individual's ability to consume goods and services depends upon their income and wealth and an inequitable distribution of income and wealth is likely to lead to a misallocation of resources and hence market failure. Some consumers might not be able to buy goods and services at all.

Equity versus efficiency

Efficiency refers to how resources can be best used in society. A market is efficient when resources are distributed optimally.

Equity refers to fairness, or what is considered to be an acceptable distribution of income and wealth in society. This could be subjective.

Price stabilisation

Price stability is important for consumers, since very high inflation or deflation can be damaging. Those on low and fixed incomes are hit hardest by inflation, due to its regressive effect, because the cost of necessities such as food and water becomes expensive. The purchasing power of money falls, which affects those with high incomes the least.

If consumers have loans, the value of the repayment will be lower, because the amount owed does not increase with inflation, so the real value of debt decreases.

Real incomes fall with inflation, so workers will have less disposable income.

If firms face higher costs, there could be more redundancies when firms try and cut their costs.

Means tested benefits and transfer payments

Transfer payments are welfare payments from the government. They aim to provide a minimum standard of living for those on low incomes. No goods or services are exchanged for transfer payments.

Examples of transfer payments in the UK include:

- Job Seeker's Allowance
- Income Support
- Child benefit
- The state pension

These are in place to ensure people have a basic standard of living and to help reduce the level of inequality in society. Transfer payments are a means for the government to redistribute income from the rich to the poor.

Means tested benefits are given based on the criteria of income and wealth. Those on low incomes might be eligible for benefits such as Income Support, for example.

Progressive income taxes, inheritance and capital taxes

A progressive tax has an increase in the average rate of tax as income increases. As income increases, the proportion of income taxed increases. For example, in the UK income tax is progressive. People have a personal allowance of £10,600 where tax is not paid. For incomes below £31,785, people only pay the basic rate of 20%. For incomes between £31,786 and £150,000, people pay the higher rate of 40%. Above this, a 45% rate is paid. This should help reduce inequality, because those on lower incomes pay less tax. The tax is based on the payer's ability to pay. Higher income households are more able to pay higher rates of tax than lower income households. Generally, direct taxes are more progressive.

There can be income redistribution and wage equality through government intervention. For example, inheritance tax means rich families cannot keep their entire wealth.

Over the last 2-3 decades, the UK has switched towards indirect taxes, which tend to be more regressive than direct taxes. The top income tax rate fell from 83% in 1979 to 40% in 1988, and it is still at this rate today.

The basic income tax rate fell from 33% to 22%, which helps workers keep more income. However, the benefits of this disproportionately favour the richest households. This has led to a worsening of the income distribution.

Inheritance is passed down generations, which means wealth is often concentrated in the hands of a few families. There can be income redistribution and wage equality through government intervention. For example, inheritance tax means rich families cannot keep their entire wealth. Moreover, state education means everyone can access education, and there is regulation for firms with monopoly power.

Negative income tax

This is a type of progressive income tax which means people on incomes below a certain level receive money instead of paying taxes. This type of tax has only been in theory so far.

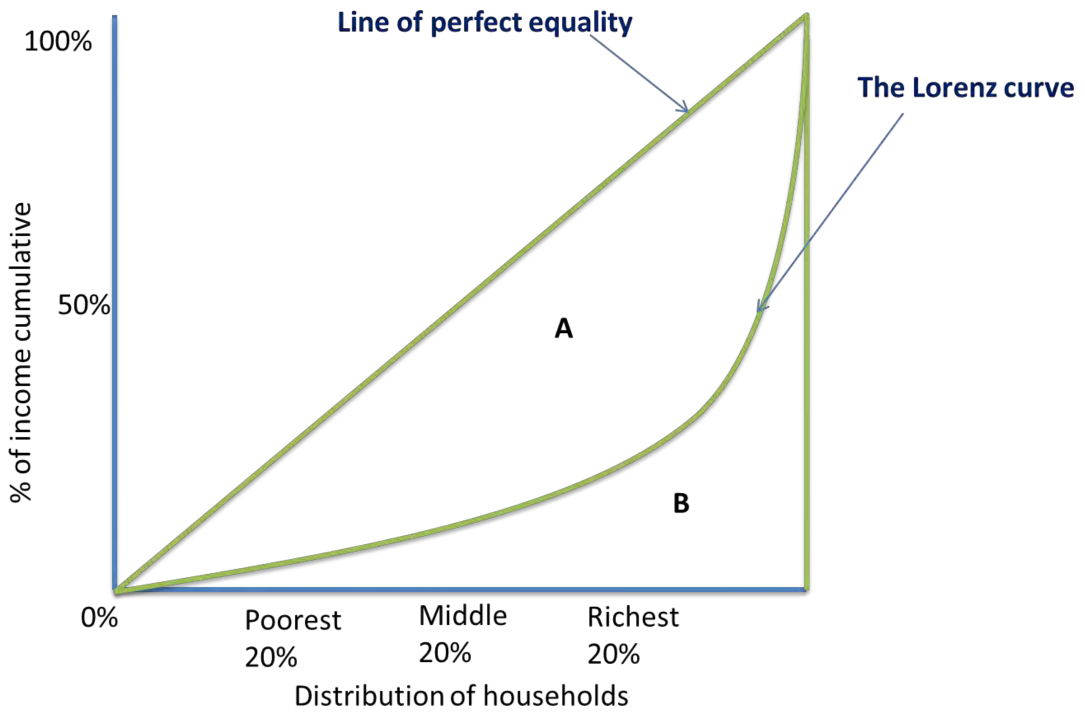
This aims to redistribute income from the richest to the poorest, thereby reducing income inequality.

Poverty trap analysis

This is a mechanism which means people are forced to stay poor and they cannot escape from poverty.

It affects those on low incomes and means they do not have an incentive to work. This is because the rate of income tax is too high and benefits might be too generous. If someone on a low income chooses to work longer, their income will be limited by taxes, National Insurance Contributions and the loss of benefits they are no longer eligible for. This means some people might end up staying on low incomes.

Gini coefficient and the Lorenz curve



The Lorenz curve measures the distribution of income and wealth in a country. The line of perfect equality shows the distribution of income when the richest *x*% of the population owns *x*% of the cumulative income.

The Lorenz curve shows the actual distribution of income and wealth. The one in the diagram shows a significant level of inequality. The richest 20% own a higher proportion of income than the poorest.
The Gini coefficient gives a numerical value for inequality and is derived from the Lorenz curve. It is calculated by the areas:

$$\text{Gini} = \frac{A}{A+B}$$

A value of 0 indicates perfect equality, so everyone has the same income and wealth. A value of 1 is perfect inequality i.e. all of the wealth in the country is concentrated in the hands of one individual or household.

Inter-generational equity

This is a concept that suggests resources, such as the environment, do not belong to a generation, but they have to be used effectively for all generations. Those in the present generation have been given control of the environment from the older generation, and they have an obligation to preserve it for future generations.

In economics, this could refer to the level of national debt, for example. If the present generation get into a lot of debt, the standard of living of future generations might be compromised. Borrowed funds should aim to improve the long term productivity of the economy and debt should not impose costs on future generations.