Edexcel Economics (A) A-level

Theme 4: A Global Perspective

4.2 Poverty and Inequality

Detailed Notes

4.2.1 Absolute and relative poverty

Absolute poverty:

- Absolute poverty is when people are **unable to afford sufficient necessities to maintain life.** The UN defines absolute poverty as 'a condition characterised by severe deprivation of basic human needs, including food, safe drinking water, sanitation facilities, health, shelter, education and information.

- The World Bank defines anyone living on **less than US$1.90 a day** as living in absolute poverty.

- Economic development tends to be correlated with absolute poverty- the more developed a country, the fewer people in absolute poverty. In developed countries, the government tends to intervene to attempt to provide the necessities.

Relative poverty:

- Within the UK, relative poverty is a bigger issue. It will always exist in a society that is not completely equal. Relative poverty is about **people's income compared to others in their area**. Someone is said to be in relative poverty if their income falls below an average income threshold for the economy; they are at the bottom end of the income scale.

- In Britain, relative poverty is classed as those with an **income of less than 60% of median household income** (£27,300 in 2017) after deducting household costs. One in 5 people in the UK live below the official poverty line, with 14m people in relative poverty.

- Another way of defining relative poverty is those who cannot afford to buy goods which they need to buy in order to not be considered poor according to **social norms**, for example an electric fridge or mobile phone.

The **poverty line** is the minimum level of income deemed necessary to achieve an adequate standard of living in a given country. The **poverty trap** affects people on low incomes, when the tax and benefits system creates a disincentive to look for work or work for longer hours. By working longer hours, individuals may find they lose income due to income tax and national insurance contributions as well as losing some income-related state benefits.

Causes of changes:

- Poverty is caused by unemployment, a lack of skills, health problems and income dependency.

- **Absolute poverty tends to fall as GDP increases**, assuming that the state provides support to those who are unable to benefit from a growing economy.

- The two main causes of growth of relative poverty are if those on **higher salaries** see larger income growth than those on lower salaries or changes in **government spending and taxation**.

- In the UK, relative poverty has been growing for a number of reasons:
  - There has been growing **inequality in wages growth**, with the highest paid jobs seeing their wages increase higher than those on lower wages. Those in the public sector have had low wage increases and several years of falling real wages, due to the policy of austerity. The wages of the richest are now 170 times the average worker, compared to 60 times before.
  - **De-industrialisation** has increased the number of service sector jobs which tend to be lower paid.
  - There has been a growth in **underemployment, zero-hour contracts, part-time jobs and temporary jobs,** all of which mean lower wages for workers.
  - The decline of **trade unions** has left many workers unable to bargain for higher wages.
  - On top of this, **state benefits** have fallen in relative value whilst taxes have become more **regressive**.
  - Moreover, **long term and structural unemployment** has risen.

Synoptic point:

Unit 4.2 links strongly to microeconomics since it looks at the impact on individuals. It relates to the Labour markets unit in Theme 3, because of the importance of wage differentials in poverty and inequality.

4.2.2 Inequality

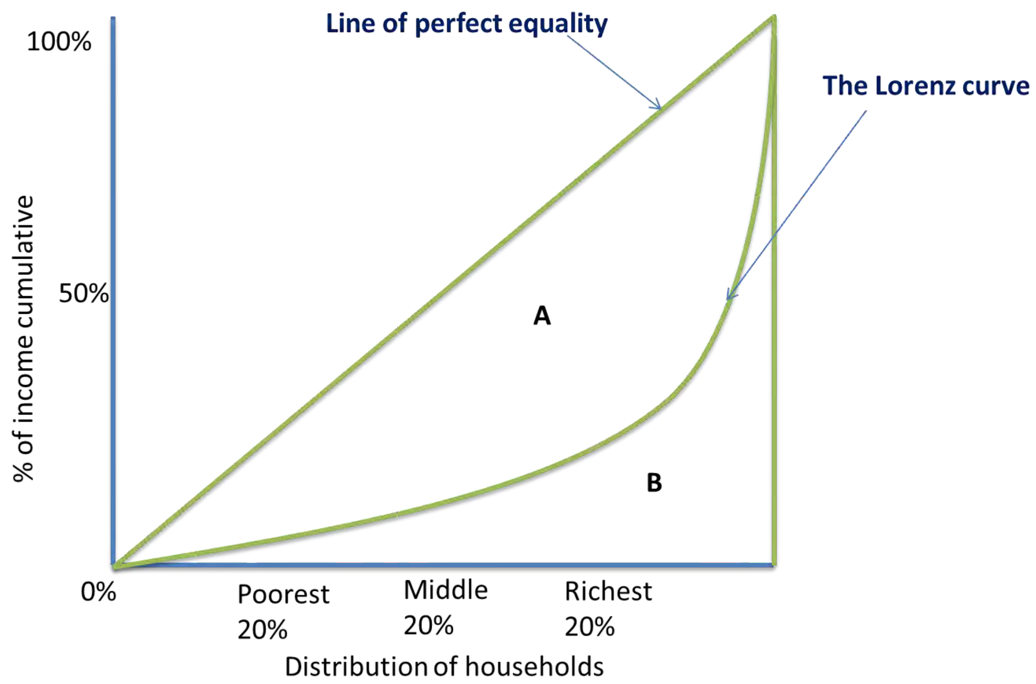
Distinction between wealth and income inequality:

- Income is a **flow** of earnings, whilst wealth is a **stock** of asset. Income inequality refers to the extent to which income is distributed in an uneven manner.

- Wealth is likely to be more unequally distributed than income because assets that make up wealth can be accumulated over time. People who are wealthy now can generate an income from those assets and as long as income exceeds expenditure, they are able to build up a stock of assets. This accumulation of wealth can occur over successive generations through inheritance.

Measurements of income inequality:

Information on distribution of income and wealth tends to be presented in percentiles, deciles and quintiles.



- **The Lorenz curve:** This shows the cumulative percentage of the population plotted against the cumulative percentage of income that those people have. A perfectly equal society would have a straight line from corner to corner; the degree of the bend away from that straight line indicates the degree of inequality.

- **The Gini coefficient:** A/(A+B)- the ratio of the area between the 45-degree line and the Lorenz curve divided by the whole triangle under the 45-degree curve. It is measured between 1 and 0 and the bigger the coefficient, the more unequal the country.

Causes of wealth and income inequality:

Within countries:

- **Wages:** Some workers simply earn more than others. This can be because of higher educational achievements, because they work longer hours or because their skills are more in demand. Those who aren't in work will have a lower income than others e.g. pensioners or those on benefits. Moreover, the higher the level of income, the more someone can save and thus the more wealth they can build up. Those on high incomes will be able to build up a stock of assets whilst those on lower incomes may have to spend most of their money on everyday items like food.

- **Wealth levels:** Someone who already has a high level of wealth, whether through inheritance or saving, is able to build up larger wealth than those on lower levels of wealth. For example, they may undertake more risky investment which will give a higher rate of return. They could buy property in London which they hope will rise in price and make a huge return. Those with lower levels of wealth are unable to do so. Inheritance often allows high levels of wealth. Moreover, high levels of wealth mean people can earn rent and interest on their assets and so therefore see increased income.

- **Chance:** Those who bought houses in the right area or bought the right assets will see a huge increase in the price of their assets and hence an increase in their wealth. They may have been lucky to inherit wealth. Those who chose the right sort of job will have seen their income rise higher than other areas.

- **Age:** Working adults at the peak of their career will earn a higher income than those who have just started. Those who are older will have had a chance to build up more assets, although some of this stock may have been used up to pay for retirement.

Between countries:

- Some countries have been held back by wars, droughts, famines and earthquakes. Certain social groups may have been excluded and marginalised. Developed countries tend to favour each other when trading, negotiating etc. and this helps them to develop more than countries who are not involved in the agreements.

Impact of economic change and development:

- The **Kuznets hypothesis** says that as society develops and moves from agriculture to industry, inequality increases as the wages of industrial workers rises faster than farmers. Then, wealth is redistributed through taxation and government spending and so inequality falls.

- However, **Piketty** discredited this theory by arguing that inequality rises as the country develops as the rate of return on capital grows, so the rich get richer and inequality increases.

Significance of capitalism:

- A capitalist economy leads to income inequality because of **wage differentials**. Wages vary as they are based on demand and supply, and demand and supply vary for different jobs.

- Individuals also **own resources** and thus wealth differs based on the assets they own. Wealth can be passed on or gained through saving of incomes.

- It is argued that equality can never be achieved in a capitalist society where the possibility of having more is important to encourage hard work. Without the incentive to gain more, people will not try hard or take risks since they have no reason to and this means the economy won't grow; **inequality is essential for capitalism to work**.

- A degree of inequality is necessary and desirable, but **excessive inequality causes problems** with efficiency and social justice.