Edexcel (B) Economics A-level

Theme 3: The Global Economy

3.6 Inequality and Redistribution

3.6.4 Redistribution of income and wealth

Notes

The distinction between income and wealth

Wealth is defined as a stock of assets, such as a house, shares, land, cars and savings. Wealth inequality is the unequal distribution of these assets.

Income is money received on a regular basis. For example, it could be from a job, welfare payments, interest or dividends. When income is unevenly distributed across a nation, income inequality is said to exist.

Incentives and the poverty trap

The poverty trap 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.

Taxation and the provision of services

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.