OCR Economics A-level

Macroeconomics

Topic 2: Economic Policy Objectives

2.7 Income Distribution and Welfare

Notes

Income and wealth inequality

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.

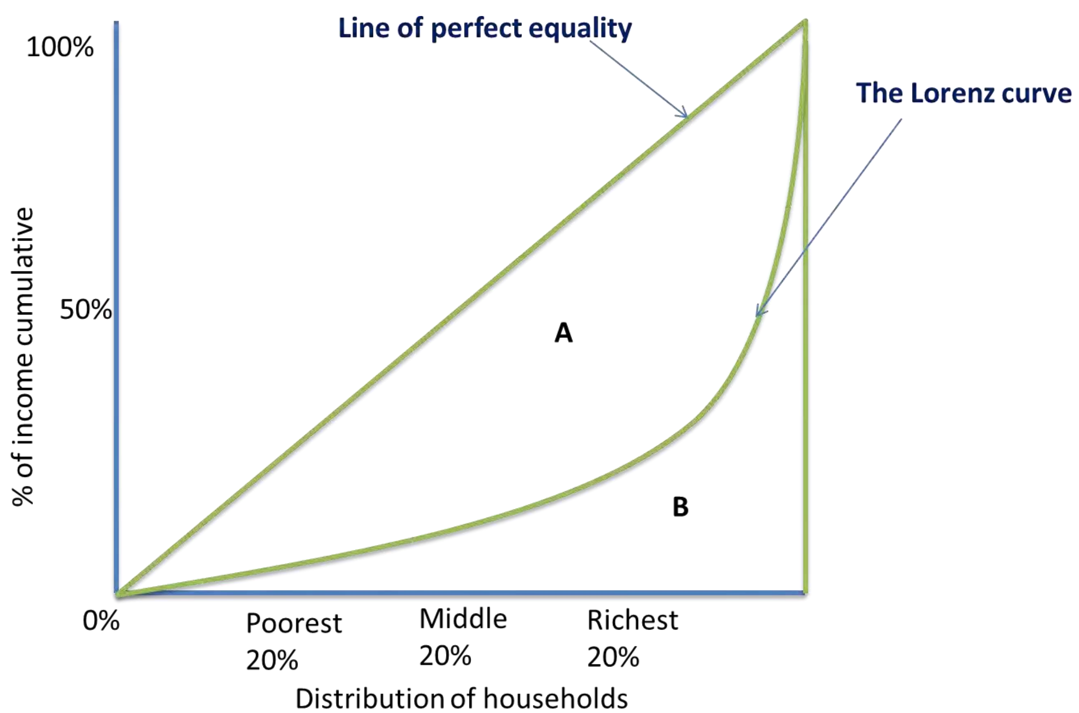
Income is money received on a regular basis. For example, it could be from a job, welfare payments, interest or dividends. When income is unevenly distributed across a nation, income inequality is said to exist.

Why achieving a more even distribution of income may be an important macroeconomic policy objective

High levels of poverty through unequal distribution of income may result in lower levels of health within the population

Having a more equal income distribution may also encourage a more cohesive society where there is less of a divide between high and low income earners.

The Lorenz Curve and the Gini coefficient



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.

Absolute and relative poverty

Absolute poverty is defined as living below subsistence. This means that the person is unable to meet their basic needs of food, clean water, sanitation, health, shelter and education. The World Bank uses a measurement based on the number of people living on less than $1.25 per day.

Relative poverty is measured by comparison to the average in the country. In the UK, those with below 60% of the median income are considered to be in relative poverty. In the US, a basket of goods which maintains the average standard of living of society is used. Relative poverty can be seen as one way of measuring income inequality.

This article from The Guardian describes the difference between poverty and inequality in the UK: http://www.theguardian.com/society/2014/sep/05/poverty-uk-better-calling-it-inequality

Causes of poverty and inequality

Inequality in wages or unemployment

If workers can earn a higher level of education, they will be able to access jobs with higher wages. Those with lower levels of education might struggle to find a job, and if they do, it might only be low paid. This is especially harmful where countries do not have a National Minimum Wage or unemployment benefits, since it can leave people in relative poverty.

Recently, more part-time and temporary jobs have been available rather than full time jobs. This leaves people underemployed, and it limits how much they can earn. It was especially a problem during the Great Recession.

The changing structure of the UK economy to services as a result of deindustrialisation has meant some jobs have been lost. This could cause structural unemployment and hysteresis. This is a type of structural unemployment, where someone is out of work for a long time, so their skills deteriorate. This makes it harder to find a job, and it leads to long-term unemployment.

Unemployment can cause relative poverty (and therefore increase income inequality), and it is particularly detrimental where no one in a household is working, since they are left to rely on state benefits.

On average, those with a degree earn more over their lifetime than those who gain just A Levels. The wage gap between skilled and unskilled workers has increased in the UK recently. Jobs in the low-skilled service industries, especially in the public sector, tend to pay less than jobs in the private sector.

Even with equal pay laws, women still earn less than men on average. This could be due to career breaks and fewer hours worked on average than men, or because women are crowded into low-paid or part-time jobs, which may only require low skill levels. Women could also be discriminated against when it comes to promotions, which effectively locks out higher paying jobs. Although a gap still exists, it is narrowing.

Workers might be discriminated against due to age, disabilities, gender and race.

Welfare payments

State pensions and welfare payments tend to increase less than wages, even though they are index-linked to inflation. This means that those on benefits see a smaller real increase in their income compared to those in jobs. This increases inequality and the number of people in relative poverty.

Taxes

In the UK, some taxes are regressive, which means that those on lower incomes bear a larger burden of the tax. This can increase inequality and relative poverty.

Over the last 2-3 decades, the UK has switched towards indirect taxes, which tend to be more regressive. 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 an increase in income inequality.

Disease, malnutrition and other health problems

Health issues can make it hard to get a job, especially in a country where jobs are scarce and rarely available. People are likely to take a lot of time off work and it can deter MNCs from investing in a country. This can leave people without an income and it can push people into absolute poverty. It is especially an issue in countries in Sub-Saharan Africa.

Wars and conflicts

This might push people to flee their homes, as well as destroying anything they owned. It could leave people homeless and force them into extreme poverty.

Corruption and political oppression

Countries with corrupt leaders might have higher levels of poverty. There is likely to be relative poverty since the leaders might keep most of the wealth.

Natural disasters

In a similar way to wars, natural disasters such as floods and earthquakes can destroy people's livelihoods. For example, the Nepal earthquake in 2015 pushed even more people into poverty. Nepal was already one of the poorest countries in the world, and their weak infrastructure was easily damaged. It was estimated that 1 million people were pushed below the poverty line after the earthquake (source: http://www.firstpost.com/world/one-million-people-fall-below-poverty-line-in-nepal-after-earthquake-2295416.html)

Inequality between countries

Globally, there is inequality between countries. Some of this is caused by certain social groups being excluded and marginalised based on ethnicity, gender, sexual orientation and disabilities.

Some countries have been held back by wars, droughts, famines and earthquakes, which has kept their populations in poverty. Across Africa, population issues are complicating efforts to reduce poverty and eliminate hunger. Their population of 1.1 billion is expected to double by 2050.

Two people born in two countries can have very different opportunities open to them, depending on where they were born. This inequality of opportunity can be seen between countries such as Japan and Sierra Leone, where the difference between life expectancies is significant. In Japan, women can expect to live to the age of 87, whilst in Sierra Leone, women can expect to live to 46.

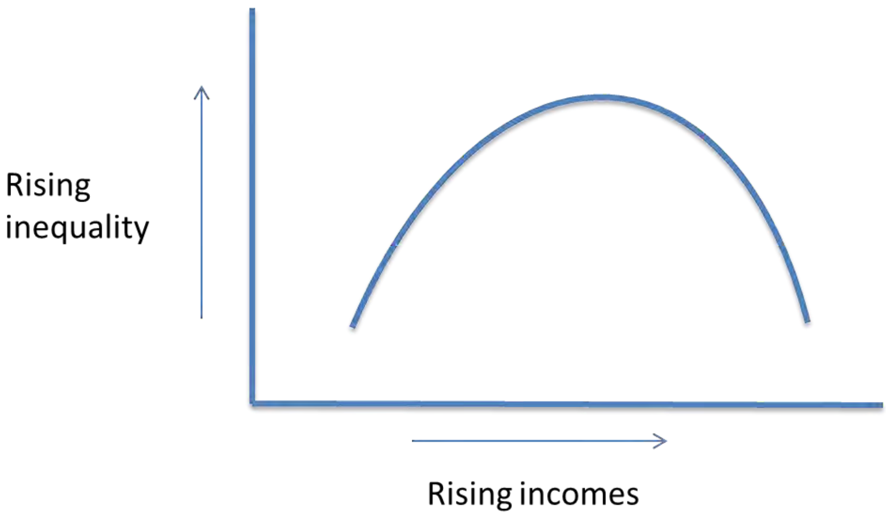
Recently, developing countries have been growing faster and are catching up with the developed world. This is helping to narrow the gap between the rich and poor countries.

The bulk of economic development happened in the Western world, even though China was the technological leader until the 1500s. This could be because British society was more open to social mobility and political liberty, and had free speech supported by Parliament which led to the growth of new ideas. Britain then became the centre of scientific revolution and experienced the Industrial Revolution. This increased output per farmer, reduced food prices and led to higher wages.

Moreover, exploitation of the poor through colonial rule led to more inequality between countries. The fast spread of ideas meant the Industrial Revolution reached much of Europe. In many countries which are poor today, war and famine held back this development. The gap in wealth, which grew during the Industrial Revolution, led to an inequality in power, and consequently was a causal factor in the exploitation of poorer countries.

Impact of economic change and development on inequality

Kuznets hypothesis states that as society moves from agriculture to industry, so it develops, inequality within society increases, since the wages of industrial workers rises faster than farmers. Kuznets curve is shown below.



Then, wealth is redistributed through government transfers and education. He essentially argued that inequality in poor countries is just a transitional phase, and once nations become economically developed, inequality reduces.

Thomas Piketty famously discredited this theory in 2014 by arguing that the capitalist free market system inevitably leads to continued inequality. The rate of return on capital increases, so as the rich get richer with higher returns on their investments, inequality increases.

Consequences of poverty and inequality:

Impact of inequality

Inequality motivates workers, which encourages them to learn new skills and work hard. A higher wage reflects higher productivity in a capitalist society, which results in wage inequality.

Monopolies can exploit consumers with higher prices, and exploit their consumers with lower wages. This allows them to earn even higher profits.

Inheritance is passed down generations, which means wealth is often concentrated in the hands of a few families. Those who inherit lots have more wealth. They can also access the best education and therefore the best jobs, which is not accessible by those with less wealth. It results in an inequality of opportunity and income. Wealth can generate more income for the rich, which widens inequality.

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.

Inequality could discourage and demotivate those on lower incomes from participating in society. 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.

Impact of poverty

- **Health:** high rates of poverty are associated with lower life expectancies, poorer standards of health and underdeveloped infants. Malnutrition is an important issue, which results in poor cognitive development in children, so they are not as productive as adults. Malnutrition also makes children more vulnerable to infections, which increases their risk of death.
- **Society:** Poverty could result in poor housing, crime and mental health issues. Social unrest becomes more common and it can create problems within communities.
- **Poor sanitation:** Many people living in poverty cannot afford basic levels of sanitation, and clean water is a rarity. This makes people more vulnerable to fatal

diseases. Usually, the diseases contracted from poor sanitation are avoidable, but they simply cannot afford to improve their situation.

- **Education:** Sometimes, families have to choose between eating and getting an education for their children. Children might have to be sent to work to support the family, which leaves them with poor literacy skills later on in life. This limits their ability to escape poverty as an adult.
- **Economy:** Without a basic level of education, the higher paying jobs, with opportunities for career progression, are not accessible. This hinders the economy's ability to improve its productive potential. For example, roughly 22% of India's population is still in poverty, which is limiting their rate of economic growth.