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Economics Revision Focus: 2004

A2 Economics

Poverty, Inequality and Government Intervention

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Revision Focus on Poverty, Inequality and Government Intervention

A2 Syllabus Requirements:

Knowledge of the distribution of household income and wealth in the United Kingdom is expected. The various factors which influence the distribution of income and wealth should be understood.

Candidates should understand the difference between **equity** and **equality**. They should recognise that people hold different views concerning what is fair and that these views will influence policy prescriptions. They should be able to distinguish between **horizontal** and **vertical equity**.

Candidates should understand the difference between **relative** and **absolute poverty**.

Knowledge of the **policies which are available to influence the distribution of income and wealth** is required. Candidates should be able to discuss the economic consequences of such policies and be able to **evaluate the various approaches to alleviating poverty**.

Key facts about the distribution of income and wealth in the UK

Income is a flow of factor incomes to households such as wages and earnings from work; rent from the ownership of land and interest & dividends from savings and the ownership of shares

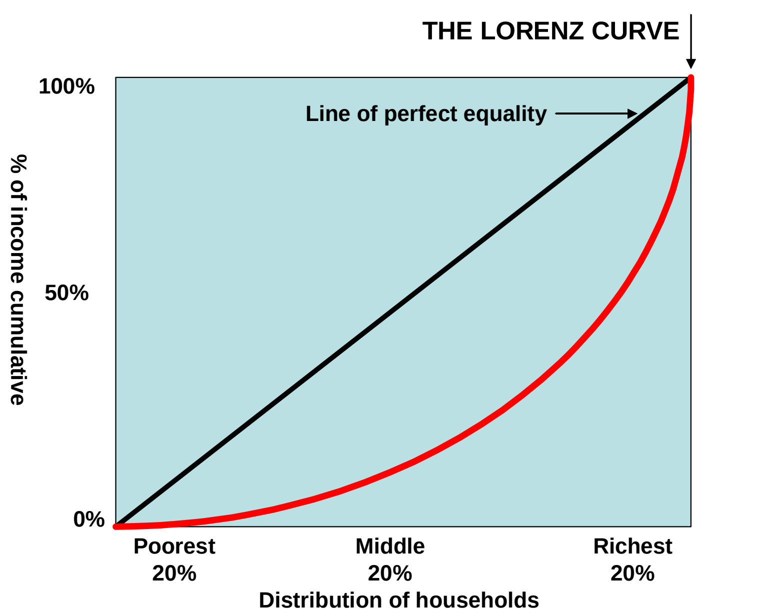
Wealth is a stock of financial and real assets such as property, savings in bank and building society accounts, ownership of land and rights to private pensions, equities, bonds etc

We measure the distribution of income and wealth by using concepts such as the **Lorenz Curve** and the **Gini Coefficient**.

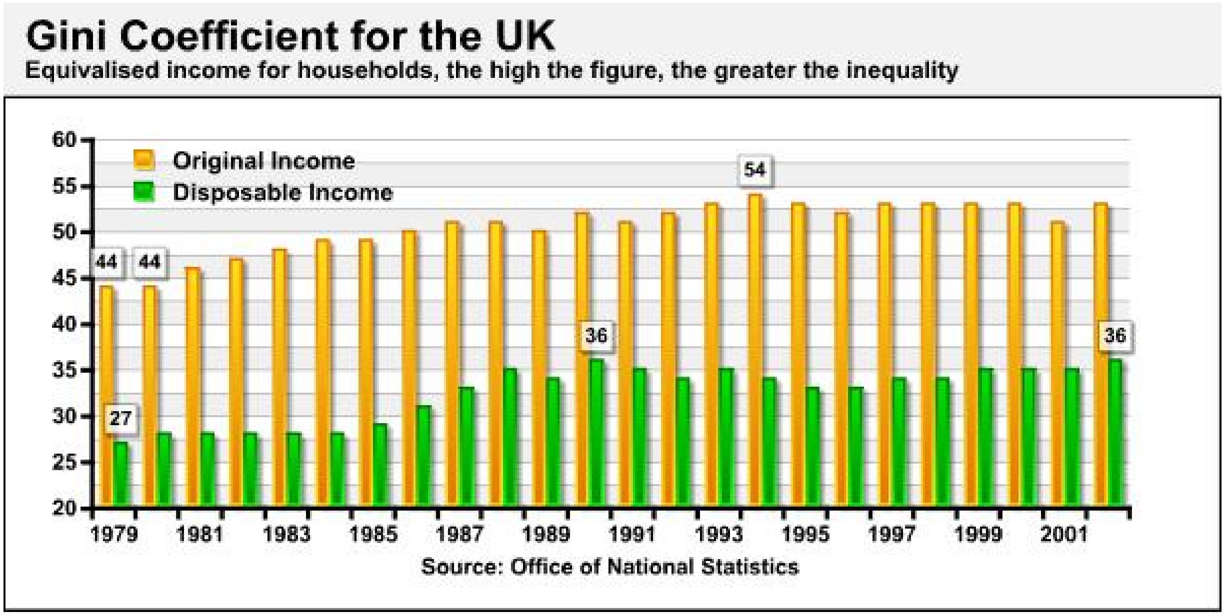
The further the Lorenz curve lies below the line of equality, the more unequal is the distribution of income. There are problems with the Lorenz curve – particular if we are inaccurate in our measure of incomes across the distribution of households in a country

The Gini Coefficient is derived from the same information used to create a Lorenz Curve.

The Gini Coefficient can take values from 0 to 100 per cent where a value of zero would indicate that each household had an equal share of income, while higher values indicate greater inequality.

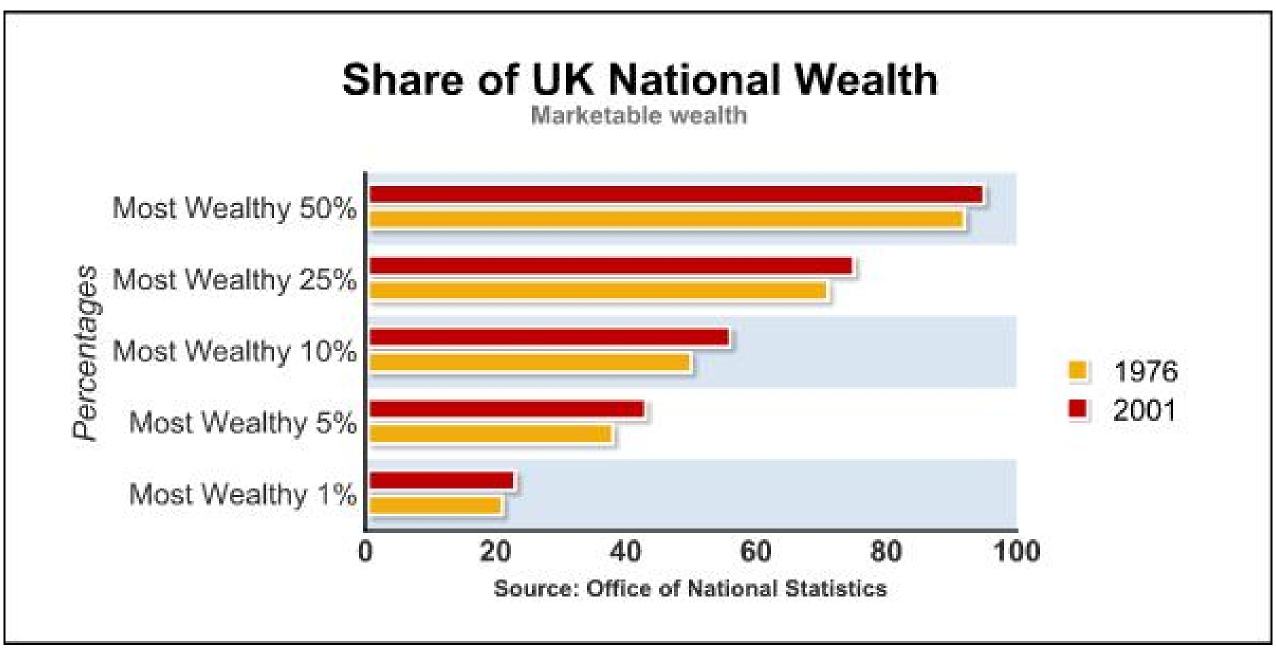


The chart on the next page shows the trend in the Gini Coefficient for original and disposable incomes of UK households since the late 1970s. Inequality of disposable income was fairly stable in the first half of the 1980s then increased during the second half of the 1980s. Inequality was relatively flat in the 1990s but with some indications of a slight fall in the first half of the 1990s and a slight rise since then. In 2001-02, the Gini coefficient was back to its 1990 level.



Inequality of original income (before taking account of taxes and benefits) has followed a different pattern. It rose fairly steadily throughout the 1980s and has been relatively stable since then. The Gini Coefficient for disposable income is lower than for original income because of the equalising effects of our progressive tax and benefits system.

The distribution of wealth is more unequal than the distribution of income. This is shown in the chart below. In 2001, over 90% of marketable wealth was in the hands of just half the population and over a fifth of wealth was highly concentrated among the richest one per cent of households.



Explaining the scale of income and wealth inequality in the UK

> The most visible evidence of excessive inequality is boardroom pay, which long ago severed its links with economic fundamentals. In the US, annual pay packages of $15m-$45m (£8.5m-£25.5m) reflect top executives' greed rather than their productivity or scarcity value. A frugal Scot such as Adam Smith would have judged them a disagreeable product of market and regulatory failure rather than a sign of efficient resource allocation. But the problem is much broader: on both sides of the Atlantic, the top 10 per cent is pulling away from the bottom 90 per cent. And the real elite - the top 1 to 2 per cent - is pulling away even from the relatively favoured top tenth.
>
> Michael Prowse, Financial Times, 22nd April 2004

There are numerous explanations both for the existence and persistence of a huge divide in incomes and wealth within the UK. Most of them are directly economic in origin, but some are linked to social change. A summary is provided below:

(1) Differences in pay in different jobs and industries

High growth industries have enjoyed above average increases in pay and earnings. These include financial and business services and information technology. Jobs where labour demand is high and there are persistent shortages of skilled labour tend to offer more generous pay packages for employees. In contrast, public sector service jobs have seen a decline in relative pay levels because pay in private sector jobs has tended to out-strip earnings growth.

The worst paid jobs are still found in low-skill service sector industries - often where there is little trade union protection and where job insecurity is endemic.

Income inequality tends to rise during periods of rapid wage growth because the poorest households are the most likely to contain non-working individuals. And because wages will rise most quickly for those workers with skills that are in high demand.

Falling relative incomes of people dependent on state benefits

State welfare benefits normally rise in line with prices (they are index-linked) rather than with earnings. Therefore, households dependent on welfare assistance see their relative incomes fall over time. This is a particular problem for many thousands of pensioner household.

The effects of unemployment

Unemployment is a key cause of relative poverty (i.e. an increase in income inequality). For example, a serious problem is the increase in the number of households where no one is in paid employment and where a family is dependent on state welfare aid.

Changes to the tax and benefit system

Changes to direct and indirect taxes have contributed to an increase in relative poverty. Income tax rates have fallen over the last two decades. The top marginal rate of tax fell from 83% in 1979 to 40% in 1988 where it has remained. The basic rate has come down from 33% in 1979 to 22% today. These tax reductions allow people in work to keep a higher proportion of their earned income. The benefits from lower taxes have flowed disproportionately to people on above-average incomes because of a fall in the progressive nature of the UK's direct tax system.

There has been a switch towards indirect taxes in recent years including higher rates of value added tax and higher excise duties on petrol, alcohol and cigarettes. Some of these indirect taxes have a regressive effect on the distribution of income.

Equity and equality

Equity is a hugely important issue among economists. You should be looking to make a comment on equity on a wide range of economic and social issues – for example the future of the NHS, the funding of higher education and the effects of globalisation.

Equity is a **normative concept** and concerns the fairness with which scarce resources are allocated among competing ends. Inevitably there are huge disagreements between people as to what an equitable distribution of resources should be.

Some people argue for much great **equality** in the post-tax distribution of income and wealth achieved by making the tax and benefit system much more progressive. They believe that a lack of equity leads to **market failure** because each one pound of income equates to an economic vote. And since resources tend to flow to those markets where economics votes are highest, a high level of inequality can lead to what is perceived as being an unfair allocation of goods and services.

Reducing the scale of income inequality is justified on the grounds of the social costs (negative externalities) arising from high levels of poverty and social exclusion. Effectively the case for having a more progressive tax and benefits system rests on a belief that the state can play an active role in achieving greater social justice.

Other "free-market" economists believe that deliberate attempts by the government to artificially make the distribution of income and wealth more equal will penalise entrepreneurial risk-taking, damage work incentives, and ultimately undermine the competitiveness and success of market-based economic systems.

> Opponents of progressive taxation argue that governments have no right to interfere with the voluntary contracts that individuals negotiate in a market society, except in order to meet essential social needs, such as a minimal safety net for the poorest. Meeting these needs, they say, does not require relatively higher tax rates on the wealthy. They also argue that high marginal tax rates are self-defeating. They undermine incentives, and so diminish the economic pie. The apparent beneficiaries thus suffer along with the resented wealth-creators.
>
> Michael Prowse, Financial Times, 22nd April 2004

Vertical equity is the unequal treatment of unequals. **Horizontal equity** is the equal treatment of equals.

Horizontal equity is the principle that people on the same incomes should pay the same amount in income tax. In order to achieve vertical equity, taxpayers with different resources must be treated differently, for example, by having a progressive tax system.

We talk about the tax system operating fairly and we consider the welfare state as a mechanism for providing a fair basic standard of living for people living in this country. Inevitably though, our perceptions about what is "fair" are wrapped up in our own valued-judgements and beliefs.

The difference between absolute and relative poverty

Absolute poverty
Absolute poverty measures the number of households unable to afford what are agreed to be basic or essential goods and services. There is always a degree of subjectivity in deciding which goods and services should be included in a definition of a basic standard of living. The concept of absolute poverty for people living in Britain is clearly different for poor households in less economically developed countries.

Relative poverty
Relative poverty measures the extent to which a household's financial resources falls below an average income level. There is little doubt that Britain has become a more unequal society over the last 25 years reflected in a persistently high level of relative poverty.

The official relative poverty line
The poverty line is currently measured at 60 per cent of median income level – where the median is the level of income after direct taxes and benefits, adjusted for household size, such that half the population is above the level and half below it. This definition is a standard that changes as median income levels change; it is a measure of relative poverty.

How great is the scale of relative poverty in the UK?

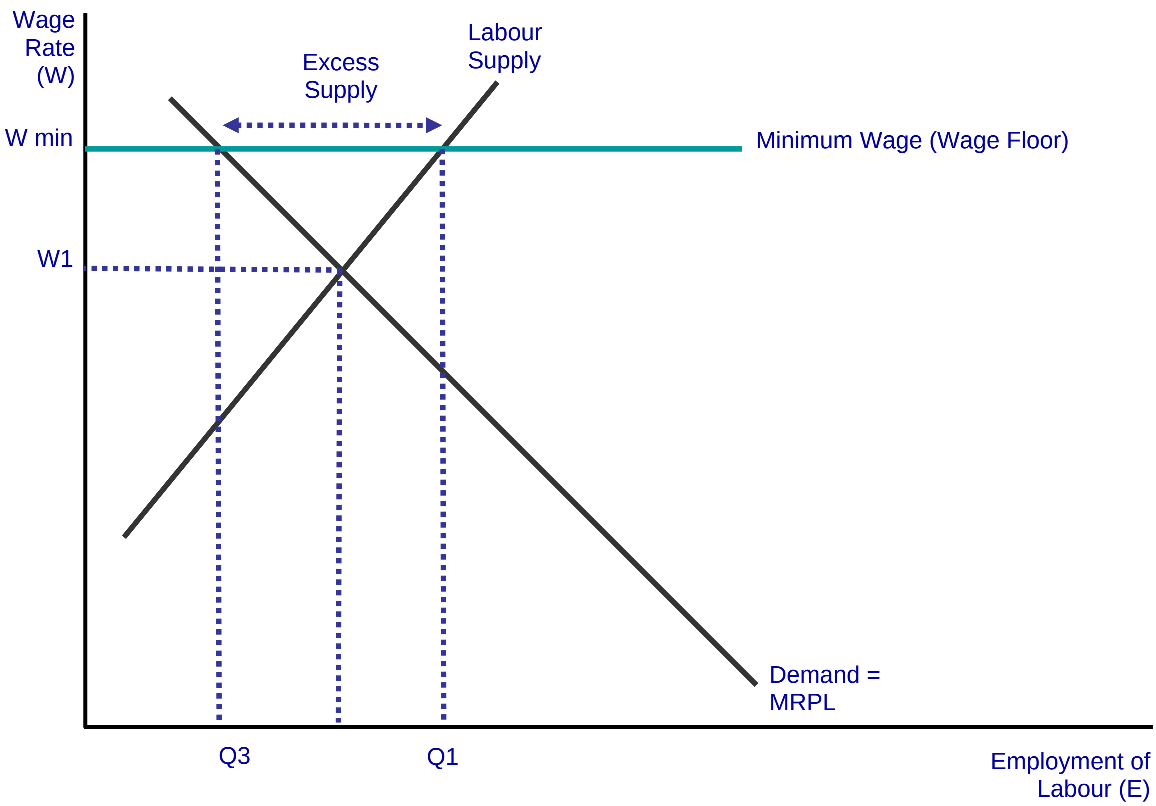
- In 2002-03, 17 per cent of the population in Great Britain lived in low income households
- Children are disproportionately present in low income households. In 2002/03, 2.6 million children were living in low income households
- Other groups of people with an above average risk of low income included workless families (those with no working age adults in work), older pensioner couples, households headed by a member of a minority ethnic group, disabled people, local authority or housing association tenants, those with no educational qualifications and those living in Inner London

Government intervention to affect the distribution of income and wealth

Here we revise the options available to the government if it wishes to achieve a greater degree of equity in the distribution of income and wealth. It may be useful to remind yourself of the main strategies that the government has chosen to reduce poverty since it was elected in May 1997.

- The introduction of a National Minimum Wage and increases in its value
- The launch of the Working Tax Credit and Child Tax Credit – designed to boost work incentives for low-income households who opt to work full-time or part-time
- Provision of Minimum Income Guarantee for Pensioners
- Winter Fuel Payments – designed to alleviate what is known as "fuel poverty"
- Employment policies such as the introduction of New Deals for young people, the long-term unemployed, lone parents and disabled people – a long-term strategy designed to increase employment opportunities

The effect of the minimum wage



And let us also consider what the government has not done!

No changes to the basic and higher rates of income tax

No restoration of the link between the basic state pension and the growth of average earnings

No increases in wealth taxes such as Inheritance Tax

The government has focused its' policies in the following areas

- Promoting higher levels of employment
- Attempting to reduce the skills gap existing in the labour market – workers with low grade skills are suffering badly in today's ever-changing labour market
- Switching towards means-tested benefits rather than universal benefits
- Offering specific financial help to certain groups
- Improving work incentives for the low paid

There has been some limited progress in attacking some of the causes of poverty. For example the number of children living in poor households fell by 200,000 in 2002-03. But the latest official figures for the UK show that, for the year 2002-03, income inequality remains greater under Labour than under the 1979-97 Conservative governments of Margaret Thatcher and John Major.

The reality is that there are powerful forces at work in the British economy (and specifically within our labour market) that are increasing the gap between rich and poor. In particular the incomes of the most affluent households have raced ahead of relatively poorer families. Thus one can argue that the government has through its redistribution policies to run simply to stand still. Without Labour's commitment to redistribution, the level of income inequality would be even higher than it is now.

Which policies are most effective in reducing poverty?

A government truly committed to making a serious dent in relative poverty would

- Invest more resources in **skills training** and **life-long education** for all households – particularly those of low income families in a bid to make a real effect on child poverty
- **Making the tax system more progressive** – for example raising the higher rate of tax from 40% for the top-earning households
- Analysing carefully the **effects of changes in indirect taxes** such as VAT and excise duty in case they have a regressive effect on the overall distribution of income
- **Focus more on targeting benefits** by means-testing them according to financial need
- **Increase the value of welfare benefits / tax credits** in line with the annual percentage growth in median earnings so that the relative value of these benefits does not decline

No policies to relieve poverty are risk free. Many are highly expensive and their effects often take many years to show through properly. The consensus among the leading academic researchers is that high employment, and a commitment to raise the skills and potential earnings of people towards the bottom of the pay ladder are the most effective and sustainable policies in the long term.