AQA A Level Economics

Your notes

7. Income & Wealth Distribution

Contents

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Income & Wealth Distribution

The Difference Between Income & Wealth

- **Income and wealth** are two different concepts
  - **Income** refers to the (flow) of money received from the **factors of production**
    - Rent, wages, interest and profit
    - **Inequality of income is caused by** the **unequal** distribution (flow) of income to households
  - **Wealth** refers to the stock of **assets** that households own
    - E.g Property, **shares**, art, pension schemes
    - Assets can be used to generate a flow of income
    - **Wealth inequality** refers to differences in the number of assets that households own

Causes of Wealth & Income Inequality

- There are numerous factors that influence the **distribution of income** and **wealth**

Causes of Wealth & Income Inequality

Cause	Explanation
Human capital	▪ The higher the **skill level,** the higher the level of **income** ▪ A country with a poor education system will see **greater inequality** than one with a good education system
Inequality of opportunity	▪ **Access to education and health** can vary significantly within communities and between different regions ▪ Inequality in education and healthcare leads to inequality of opportunity in the **job market**
Assets	▪ **Assets** generate income and increase in value ▪ These assets are then passed on to the next generation through inheritance or gifts, **widening wealth disparities**

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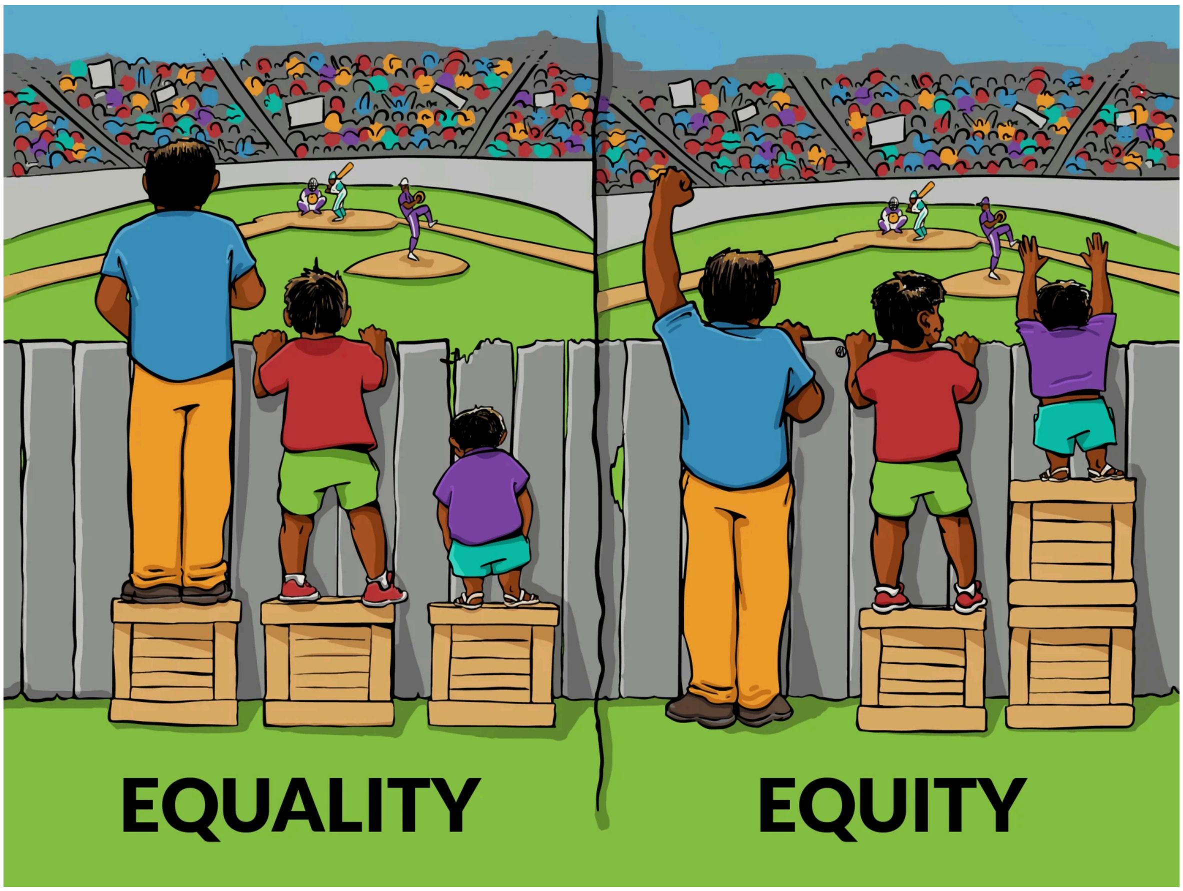
Discrimination	▪ Gender, race or any other **discrimination** increases income inequality in an economy
Unequal power	▪ Countries with strong **trade union** membership provides workers with more power and higher levels of income ▪ With **low trade union membership**, the exploitation of workers through low wages is easier and income inequality is worse
Government policies	▪ Countries that provide a r**ange of benefits** (such as unemployment, pension, disability, child support, housing support, etc) **raise the income** of the lowest 20% of the population, resulting in more equal distribution ▪ **Progressive tax systems** allow all income earners to contribute to public revenue according to their ability ▪ Decreasing taxes on the lower end and increasing it on the upper end would mean that the system is more progressive and there would be a more equal distribution of income
Globalisation	▪ Globalisation is the economic integration of different countries through increasing freedoms in the cross-border movement of people, goods/services, technology and finance ▪ This **integration of global economies** has impacted national cultures, spread ideas, speeded up industrialisation in developing nations and led to **de-industrialisation** in developed nations ▪ Countries which are more isolated will experience higher levels of wealth and income inequality
Market based supply-side policies	▪ **Supply-side policies** such as **deregulation**, **privatisation** and **trade liberalisation** can provide great opportunities but also increase inequality ▪ E.g. **Privatisation** of state owned assets often allows a few people to get rich (those who buy the asset), however, the service provided by the **newly privatised firm** may become more expensive to access

The Distinction Between Equality & Equity

- **Equality** describes situations where economic outcomes are similar for different people or different social groups
  - **Income equality** would mean everyone, irrespective of their job, is paid the same

- Inequality in the **distribution of income** is one cause of absolute and relative poverty
- **Equity** refers to the idea of fairness and is a **normative concept**
  - **Equity in the distribution of income** means that there is fairness in the **wage differentials** that exist in society, e.g. those with higher qualifications or skills are paid more than those with less
  - The size of **acceptable wage differentials** is a matter of much debate

Diagram: The Distinction Between Equality and Equity



Equity is a normative concept and carries the idea that those who need more help, get it (two boxes). Those who need less help, receive less (one box). Those who need no help, can stand alone

(Interaction Institute for Social Change | Artist: Angus Maguire)

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The Lorenz Curve & Gini Coefficient

The Lorenz Curve & Gini Coefficient

- The two main measures of income inequality are the **Lorenz Curve** and the **Gini coefficient**

The Lorenz Curve

- The Lorenz Curve is a visual representation of the income inequality that exists **between households** in an economy
- Data is commonly presented in **quintiles** (population divided into five groups, i.e 20%) or **deciles** (population divided into ten groups i.e 10%)
    - E.g. In 2020, 49% of the **income flow** in Bolivia went to the **top 20%** of households, while only 4% went to the **bottom 20%**
- **Perfect income distribution** is not the goal (20 % of the population gets 20% of the income; 40% gets 40% of the income etc.)
    - That would equate to socialism and completely **remove incentives for work,** as everyone would be paid equally
- More equal income distribution is desired as it **reduces poverty** and social unrest
    - What constitutes acceptable income equality is a **normative** economic issue

Diagram: Lorenz Curves for Sweden, the UK and Bolivia

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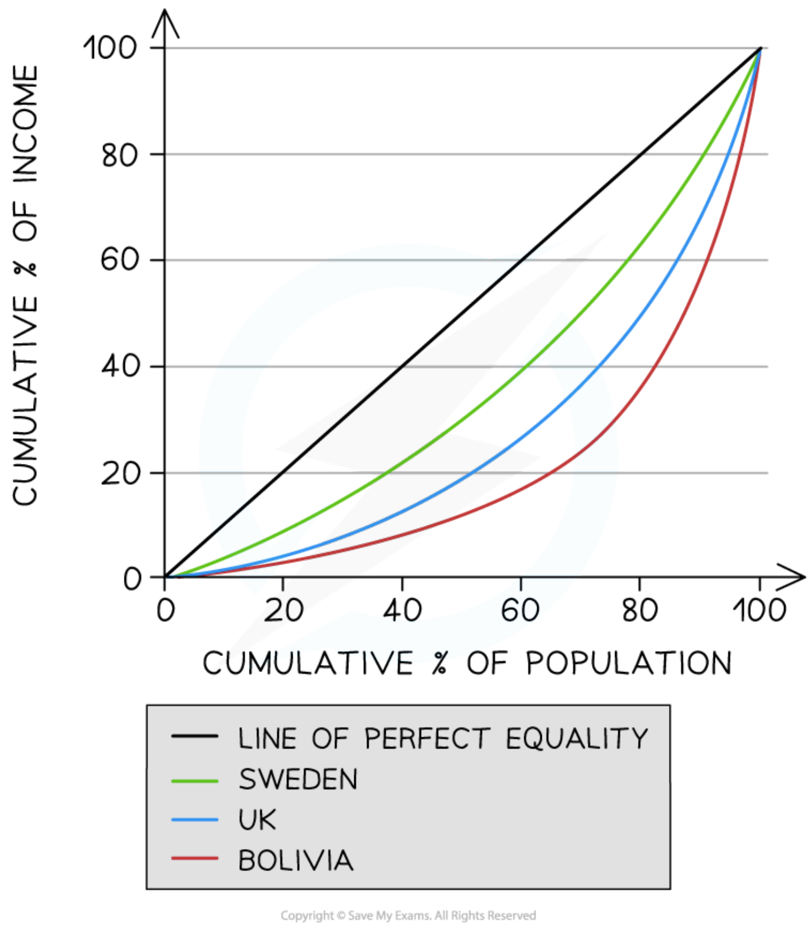

An illustration of income inequality for Bolivia (blue line), Sweden (red line), and the UK (yellow line) using a Lorenz Curve Model. The income distribution in Bolivia is more unequal than that of Sweden

Diagram analysis

- The **line of equality** represents perfect income distribution (not desirable)
- In Bolivia the **bottom 20%** of households receive 4% of the income flow, while in Sweden they receive 9% of the income flow
- In the UK, the **top 10%** of households receive 45% of the **income flow,** while in Sweden they receive 25%
- Sweden has a **more equal** distribution of income than the UK

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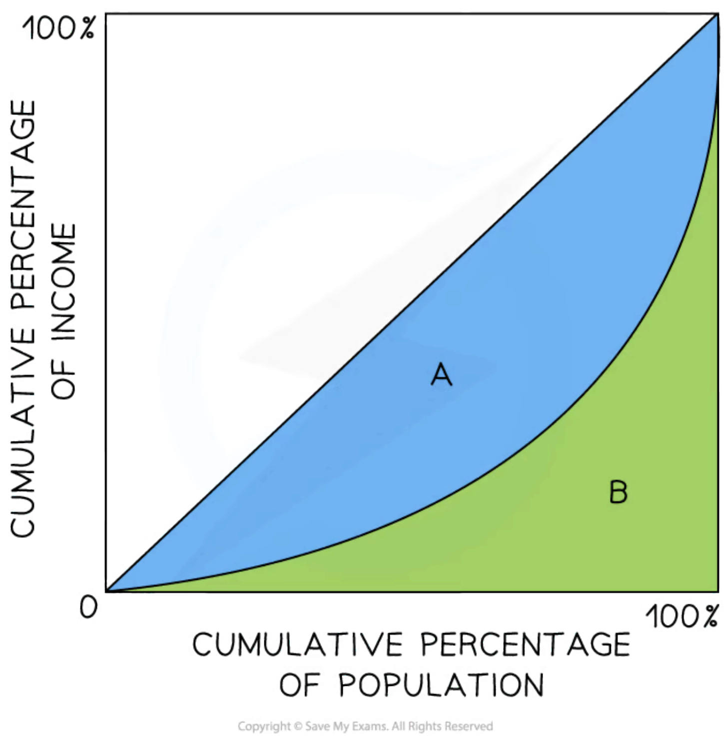
The Gini Coefficient

- The Lorenz curve can be used to calculate the **Gini Coefficient**

Diagram: How the Gini Coefficient is Determined



The Gini Coefficient is calculated using the area beneath the line of equality

Diagram analysis

- $\text{Gini Coefficient} = \frac{A}{A + B}$
- **A** represents the area between the line of equality and Bolivia's Lorenz curve
- **B** represents the area under the Lorenz curve
- A value of 0 represents **absolute equality** (socialism) and 1 represents **perfect inequality**
- In 2017, Estonia's coefficient was 0.3, compared with a value of 0.62 in South Africa
  - The distribution of income in Estonia was more equitable than in South Africa

- Governments use **progressive taxation** and **transfer payments** to shift the Gini coefficient closer to zero

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Worked Example

Using a Lorenz curve diagram, explain what happened to income inequality in Bolivia between 2008 and 2016

Income Gini Coefficient Data for Bolivia

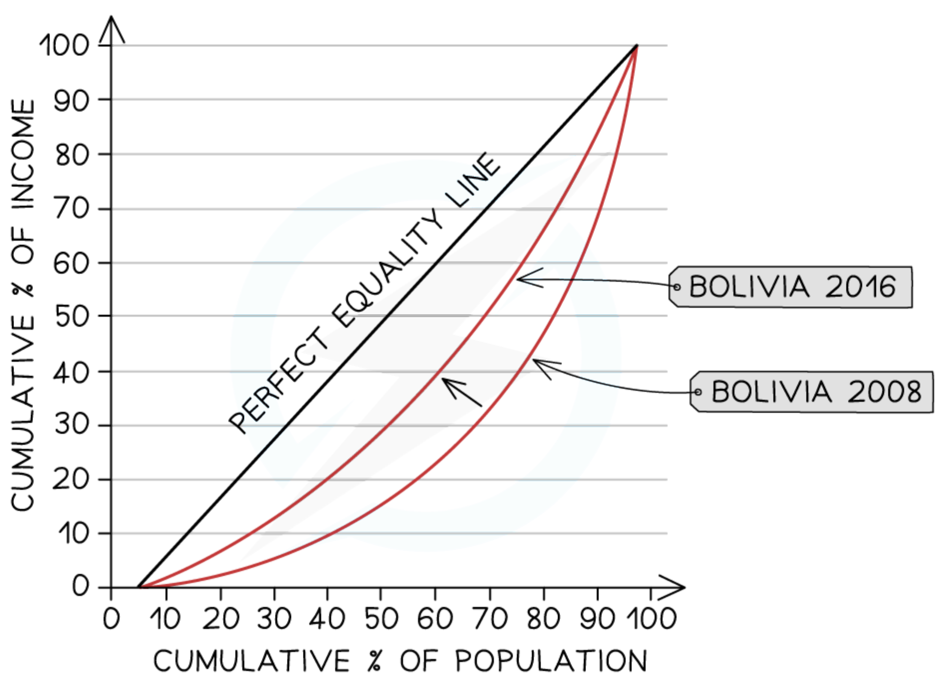
Income Gini Coefficient 2008	0.51
Income Gini Coefficient 2016	0.43

Step 1: Determine if inequality has improved or worsened

The closer to zero, the closer the country is to perfect equality

The situation in Bolivia has improved so the Lorenz curve is moving closer to the line of perfect equality

Step 2: Draw and label the Lorenz Curve for each year



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Step 3: With reference to your diagram, explain what has happened to the income inequality between the two time periods

The closer the Gini coefficient is to zero, the more equal the distribution of income in a country. Bolivia's Gini coefficient has moved closer to zero, indicating that there is less income inequality in 2016 than there was in 2008. This is illustrated by an inward shift of the Lorenz curve towards the line of perfect equality

Benefits & Costs of Unequal Distribution of Income & Wealth

- **Capitalism** is at the heart of free market economics
    - Under Capitalism, **inequality is inevitable**
    - Workers with higher skills receive higher wages
    - Workers with little to no skills receive little to no wage
    - Individuals with higher income will **acquire more assets,** leading to higher levels of income
        - In turn, they can keep on acquiring assets
        - Individuals with lower income will find it **hard to acquire assets**
- The principles of capitalism are considered important as the incentive to acquire income raises productivity and output
- However, the long-term outcome of capitalism is that the **factors of production** become concentrated in ownership, with relatively few individuals developing extreme wealth, at the expense of many who lose out
    - This increases income and wealth inequality

Costs of Unequal Distribution of Income & Wealth

Impact	Explanation
Disincentives	▪ Increasing levels of inequality can act as a **disincentive** for workers to work and be productive as there is a sense that society is unfair ▪ This can result in a decline in **economic growth** and an increase in unemployment payments and **welfare benefits**

Living standards	▪ If the **inequality gap grows**, the rich get richer and the poor, relatively poorer, which will reduce the **standard of living** ▪ The wealthier will access better education and healthcare, creating even less opportunity for poorer households in the future
Social stability	▪ More equal societies tend to be more **stable, tolerant and considerate,** with lower levels of crime and better standards of living ▪ Less equal societies tend to be characterised by **political instability, strife, and social unrest,** and in extreme cases this can lead to revolutions

The Problem of Poverty

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The Difference Between Relative & Absolute Poverty

- **Absolute poverty** is a situation where individuals cannot afford to acquire the **basic necessities** for a healthy and safe existence
  - These necessities include shelter, water, nutrition, clothing and healthcare
  - In 2022, the **World Bank** defined absolute poverty as anyone who was living on less than **$1.90 a day** (the so called international poverty line)
  - Absolute poverty is more prevalent in **developing countries** than in developed ones
- **Relative poverty** is a situation where household income is a certain percentage less than the median household income in the economy
  - Poverty in a household is considered relative to **income levels** in other households
  - Households that are living with less than 50% of the **median household income** are considered to be in relative poverty
  - Relative poverty is the main form of poverty that occurs in **developed** countries

Causes & Effects of Poverty

- There are many causes of poverty. However, poor countries have several common characteristics, which can be summarised in a **poverty cycle**

Diagram: Poverty Cycle Diagram

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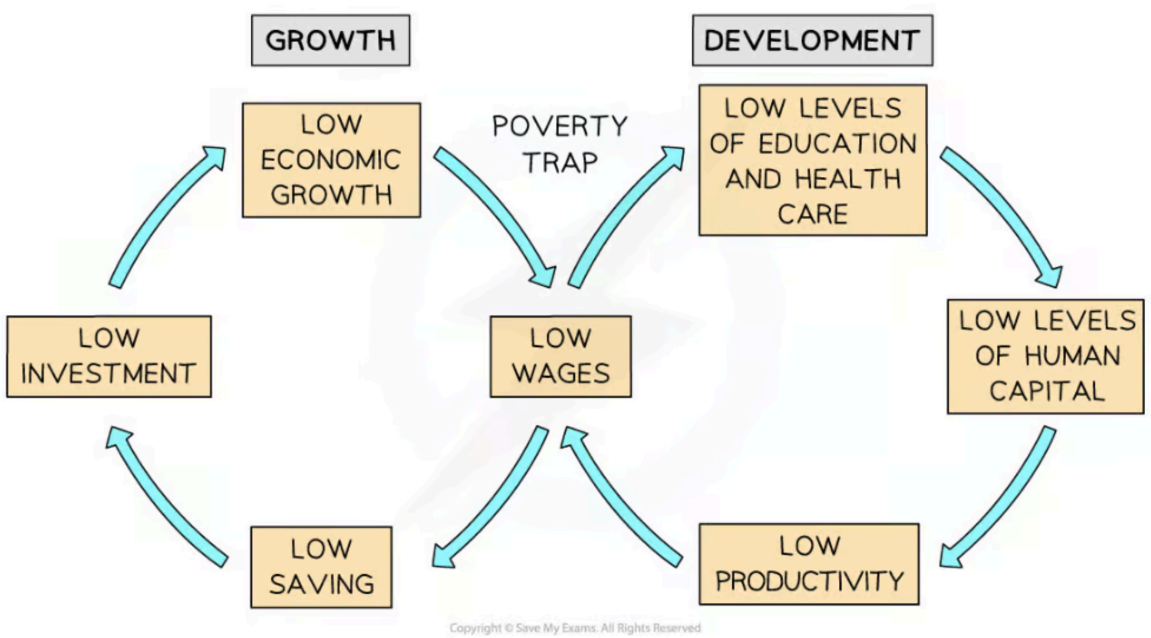

Poverty is caused by a lack of both economic growth and human development

- **Low wages** represent the intersection of **economic growth and human development** and are the major cause of poverty
  - Low wages are usually the result of **unemployment**, **informal employment**, a lack of skills, or a **primary sector** based economy
- **Education and healthcare** cost money and with lower wage levels, these are not accessible, resulting in poor **human capital**
  - People find it harder to stay well or recover from illness, resulting in **lower productivity** and **shorter life expectancy**
- **Low productivity** results in low wages, and the cycle continues
- **Populations** with a large number of **dependents** (old people and children) for each working household tend to experience **higher levels of poverty**

Examiner Tips and Tricks

> You do not need to know the poverty cycle diagram for your exams. However, it is an incredibly useful tool to understand and explain the causes of poverty.

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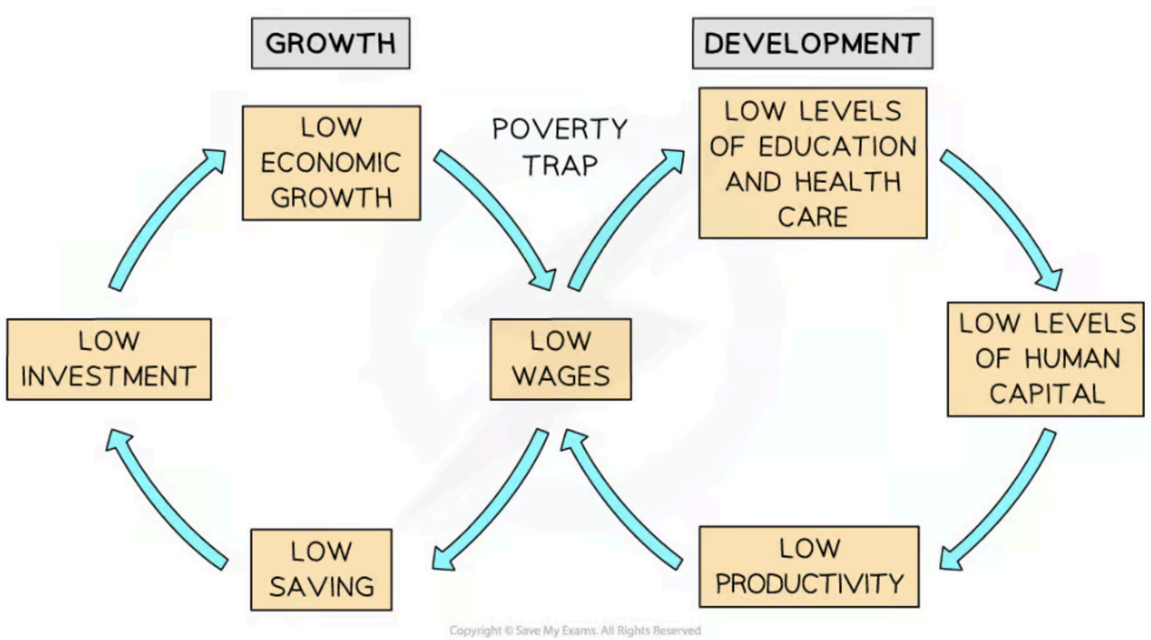
Government Policies to Reduce Poverty & Inequity

Policies to Alleviate Poverty & Address Income Inequity

- The **poverty cycle diagram** (below) was introduced in the previous subtopic and helps to explain the **causes of poverty**
- **Any policy** that helps to **break the poverty cycle** at any point will help to improve the **standards of living** within a country
- **Policies** used to alleviate poverty include **promoting economic growth**, improving education, providing more generous state benefits, progressive taxation, and the establishment/increase of a **national minimum wage**

Diagram: Poverty Trap



Policies which help to improve any factor in the diagram will help to alleviate poverty and improve equity

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How Different Policies Alleviate Poverty

Policy	Explanation	Impact on Poverty Cycle
Reducing the use of protectionist policies	▪ Removing **protectionism** or engaging in expansionary demand and supply-side policies will **promote growth** ▪ Data shows that **economic growth** has a very positive impact on **economic development** ▪ In most cases, **growth precedes development** ▪ Often in less developed countries, economic growth is linked to **one industry** and generates many **negative externalities of production,** possibly resulting in decreased living standards	Higher growth → **higher wages** → better education/healthcare → better human capital → better productivity → higher income
Education	▪ Investing in this **supply-side policy** increases the potential output of the country (shifts the **production possibility frontier** outwards)	Higher education/skill levels → **higher human capital** → increased productivity → higher output → higher income
State benefits	▪ State benefits are usually given to the **poorest and most vulnerable** people in society ▪ State benefits include **unemployment and disability payments**, pension payments, heating discounts, public transport subsidies etc.	More benefits → **higher wages** → better education/healthcare → better human capital → better productivity → higher wages
Progressive taxation	▪ A **progressive tax system** is one that applies higher levels of income tax to higher levels of income i.e lower income earners pay a lower tax rate than higher income earners	Higher redistribution → **better education/healthcare** → better human capital → better productivity → higher income

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	▪ Tax revenue collected is then redistributed to those who need it most ▪ Redistribution often starts with the provision of **free education and healthcare** ▪ Sometimes the benefits of a good **progressive tax** system are eradicated by the penalties imposed through multiple **regressive** (indirect) taxes	
Minimum wage	▪ **National minimum wages** are set above the free market rate ▪ Firms are not allowed to pay anyone less than the **legal rate** ▪ **This raises the level of income in poorer households**	**Higher wages** → better education/healthcare → better human capital → better productivity → higher wages

Economic Consequences of Policies

- **Free market economists** argue that any government intervention in the free market creates **inefficiencies and reduces incentives**
- Reducing poverty and inequity can have both positive and negative **economic consequence on:**
  - Employment
  - Economic growth
  - Government finances

Economic Consequences of Policies

Consequence	Explanation
Employment	▪ Employment may increase as there is an incentive for households to increase the supply of labour if **minimum wages** increase ▪ On the other hand, employment levels may fall as **progressive taxes** increase and there is a disincentive to work ▪ Firms may also demand less labour if the cost of hiring increases

Economic growth	▪ Higher levels of income may promote spending and **increase economic growth** ▪ However, **higher taxes** increase **production costs** and may cause firms to leave the country in favour of a lower tax system ▪ This causes output to fall and may **lower economic growth**
Government finances	▪ Increased taxes can lead to to an increase in **government revenue** ▪ It can also lead to **fiscal drag,** where increased revenue is actually outpaced by a rise in government spending, particularly on social welfare payments and education ▪ This causes negative effects for future generations if money needs to be **borrowed to fund policies**

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