Income distribution and welfare

Causes of income inequality

- **Inequality in wages and earnings growth**. Workers with high levels of skills will be able to gain higher wages. However, those with few skills or qualifications will find themselves unemployed or in low paid jobs.
- **Unemployment.** High levels of structural and long-term unemployment are one of the biggest causes of poverty in the UK because the unemployed rely on government benefits, which are substantially less than wages.
- **Monopsony / monopoly.** A powerful firm with monopsony power can pay low wages to workers and keep high profits for shareholders.

Causes of wealth inequality

- **Opportunity to save.** Those with low income do not have any disposable income to save and increase wealth. High income earners may have substantial spare cash.
- **Rent and accumulation**. Those who are wealthy (e.g. own a house) can gain rentable income, which they can use to invest in the accumulation of more assets.
- **Inheritance.** Wealth can be inherited, income cannot.
- **Tax**. Taxes on income tend to be higher than taxes on wealth.

Is inequality necessary?

- Incentives play an important role in a free market. People need incentives to take risks and make the effort of setting up a business.
- Without the prospect of higher income, enterprise would be limited. Therefore a degree of inequality is needed in a free market economy.
- Policies to reduce inequality may create disincentives to work, e.g. higher income tax may discourage working overtime. Benefits to the unemployed / low paid can discourage taking work (unemployment trap / poverty trap).

Problems of inequality

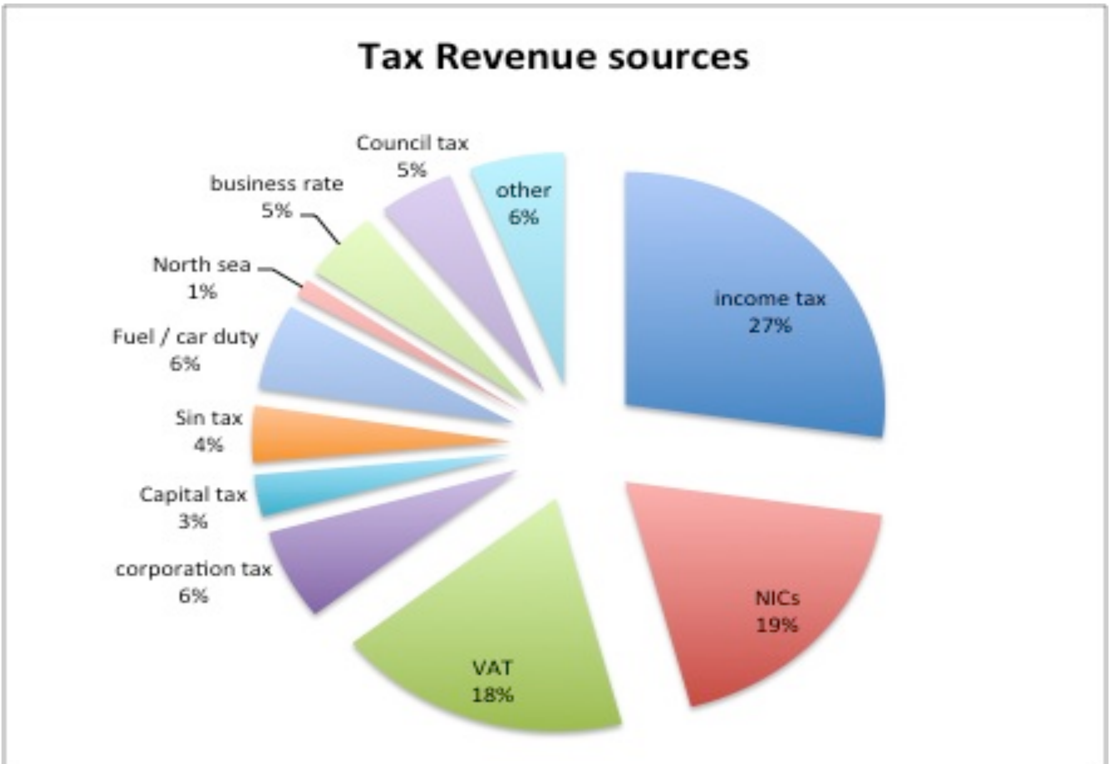
- **Exploitation**. The wealthy can exploit their monopoly power to make higher profits at the expense of others, e.g. landlords have a degree of monopoly power in setting rents, especially in places like London.
- **Social friction**. High levels of inequality can cause social friction and resentment in society.
- **Diminishing marginal utility of money**. Taking more tax from high-income earners has little impact on living standards, taking tax from low earners has a greater impact because they have to cut back on essentials.

- **Lack of access to education**. Those in low income households may find it harder to gain equity in the provision of education. Schools in low-income areas may have poorer standards of teaching and lower expectations. Supplementary education services, such as revision courses may not be available if parents cannot afford. If there is inequity in education, this can cause poverty to be passed on from parents to younger generation.

Taxation

- **Progressive tax**. This occurs when those on higher income levels pay a higher % of their income in tax, e.g. the UK has a top rate of 45% on marginal income over £150,000; this is a progressive tax.
- **Regressive tax.** This occurs when an increase in income leads to a smaller % of their income going on the tax, e.g. excise duties and VAT take a bigger % of low income earners.
- **Proportional taxation** — takes same % of income, whatever income band.
- **Direct taxation** — taken from people's earnings directly, e.g. income tax and NI.
- **Indirect taxation**. Paid by firms selling goods, e.g. VAT is included in the final price consumers pay.

UK Tax revenue sources



The requirements of a good tax system

1. Horizontal equity, i.e. those in the same circumstances should pay the same taxes
2. Vertical equity. A degree of proportionality is important, e.g. progressive income tax
3. Cheap to collect
4. Difficult to evade
5. Efficient, non-distorting, e.g. if income taxes are too high, people may be put off working
6. Easy to understand

Reasons for tax

- Raising revenue
- Promoting redistribution of income and wealth
- Discouraging consumption/production of goods with negative externalities or demerit goods

Impact of increasing the rate of income tax

- **Higher revenues**. Higher income tax should increase tax revenues. The government can spend more on public services and benefits to reduce inequality and fund capital investment.
- **Tax evasion**. Higher income tax may encourage tax evasion, e.g. higher rates of income tax could encourage people to work in another country. Therefore, an increase in tax revenues may be less than expected.
- **Incentives to work**. Higher marginal tax rates may reduce incentives to work and do overtime (The substitution effect states higher income tax will make work relatively less attractive.)
- **Redistribution**. Higher rates of income tax can help redistribute income from high earners to low earners and create more equality.
- **Aggregate demand**. Higher tax rates will reduce disposable income and lead to lower consumer spending. Ceteris paribus, this could lead to lower economic growth and lower inflation.
- **Trade balance**. Higher tax rates are likely to reduce spending on imports; this could lead to an improvement in the current account as less is spent on imports. By contrast, higher specific taxes on goods could make exports less attractive.
- **FDI**. Higher income tax and, more specifically, higher corporation tax, could discourage foreign direct investment.