

# Chapter 7: The distribution of income and wealth: poverty and inequality

## Application of economics in the real world

### Application of economics in the real world 7.1: Causes of declining labour share of income

- 1 In a business, the term 'labour' refers to the employees who work for and are managed by the company in exchange for wages. In contrast, 'capital' refers to the capital equipment that the company owns, but in a wider sense it refers to the owners of the business. In the context of the case study, workers have been adding less value to productivity since 1970 and have experienced a decline in their share of the income generated by businesses. The owners of capital, the shareholders, on the other hand, have experienced a growing share of the income.
- 2 An inward-looking policy seeks to resist or reverse the economic integration that has been part of the process of globalisation. Since the 1970s, multinational corporations have built international production platforms and sought to take advantage of the global division of labour. This has led to factories in advanced economies closing down and being relocated to emerging market economies, where labour is significantly cheaper. Businesses have been able to cut costs of production and generate higher profits for shareholders. However, workers in advanced economies have lost jobs and industrial cities have experienced decline and problems with poverty. President Trump's 'America First' agenda has seen the US government introduce a range of inward-looking policies, such as tariffs, designed to put pressure on multinational companies to close factories in emerging market economies, such as China, and relocate them in the USA.
- 3 Productivity is defined as output per unit of input. Economies generate greater income when businesses become more productive by developing new production methods that allow them to increase output with the same or lower inputs. Productivity growth means that the income 'cake' is getting larger, but if workers' wages grow more slowly, their proportionate slice of the cake is getting smaller.
- 4 Thomas Piketty has made a valuable contribution to the debate on inequality in the twenty-first century and has argued that, under capitalism, rising inequality is inevitable. His arguments have energised left-wing politicians such as Jeremy Corbyn in the UK, and Bernie Sanders and Elizabeth Warren in the USA. Piketty's research has provided the intellectual ammunition for politicians keen to build a more equal society by increasing taxes on income and wealth. In recent elections, radical politicians have stood on manifestos setting out policies that will raise the top income tax rates and introduce wealth taxes on assets.

The inequality debates rest on four main assumptions. First, in recent decades the incomes of the top 1% have increased significantly. Second, in the same period the real incomes of the middle classes have stagnated. Third, recent productivity improvements have been driven by technological advancements, so the owners of capital have received increased returns on their investments, while the wages of workers have stalled. Fourth, the wealthy have reinvested their rising incomes in assets, such as property and equities, which has further widened the inequality of wealth.

Piketty has produced valuable research that has improved our understanding of the problems that confront contemporary societies. Across Europe and North America, traditional centrist political parties have lost out to populist politicians and insurgent movements in recent years. Inequality and the need to do something for the 'left-behind communities' is a common theme. However, the extent to which Piketty's research holds up to scrutiny is unclear.

Calculating income and wealth is difficult and many economists have questioned Piketty's methodology. They have challenged the data that he has collected and found evidence that contradicts some of his findings. Ultimately, Piketty has improved the quality of the discourse on inequality but his arguments can be challenged.

## Application of economics in the real world 7.2: The case for and against a flat tax

- 1 A proportional tax is when the proportion of income paid in tax stays the same as income increases. A progressive tax is when, as income rises, a greater proportion of the income is paid in taxation. In the UK, income tax is a progressive tax. Regressive taxation is when the proportion of income paid in tax falls as income increases. Sales taxes, such as VAT in the UK, are regressive.
- 2 Tax avoidance is when an individual or business legally reduces its tax bill by using schemes designed by the government to encourage particular types of economic activity. For example, when a worker saves income in an Individual Savings Account (ISA) they are shielded from paying tax on the income they earn on their savings. In contrast, tax evasion is illegal and occurs when an individual or business fails to declare taxable income to the government. For example, if a worker earns income from employment or from interest on savings but does not declare it on a tax return, it is tax evasion.
- 3 The introduction of a flat income tax would reduce tax avoidance if the government removed tax breaks that higher-rate taxpayers use to reduce their total tax bill. However, given that these schemes are introduced by governments to encourage and incentivise particular economic activities, the government would need to identify clearly what it is trying to achieve. For example, tax relief is given to higher-rate taxpayers when they donate money to charity or save money in a pension scheme. Removing these 'loopholes' that allow workers to avoid tax will reduce charitable giving and create disincentives for high-income workers to save for their retirement.

A flat tax may reduce tax evasion by reducing the overall tax burden of high-income workers. In the UK, the higher rate of tax is 40% and the additional rate of tax is 45%. If the UK government were to follow the example of Estonia and reduce income tax to 26%, this would give higher-income groups a significant tax cut. The lower rate of income tax might mean that some groups that currently engage in tax evasion decide that the opportunity cost of being caught is too high and they will declare all of their income in the simpler, flat-tax system. However, the flat-tax system will pull many low-income groups into a higher tax band. In 2019, 43% of UK households did not pay income tax, and many of those who did only paid some of their income at 20%. The introduction of a flat tax at 26% would see millions of low-income groups paying higher taxes while a smaller group of high-income households would benefit from lower tax bills.

- 4 Massive cuts in public spending would mean that the largest government departments would need to reduce their budgets significantly and provide more limited public services. The three largest government spending areas are social protection, health and education. In 2019/20, the government spent £252 billion on social protection (31% of total spending), £155 billion on health (19% of total spending), and £102 billion on education (12.6% of total spending).

The social protection budget can roughly be divided into three main areas: pensions, housing benefits and welfare benefits that provide a major source of income for low-income households. In 2019/20, only 2% of social protection spending was on unemployment payments. Large cuts in these budgets would significantly reduce the incomes of low-income households and might lead to an increase in homelessness and poverty. Many pensioners are too old to work. A cut in pensions will lead to all pensioner households having less money and

will mean the poorest, who are reliant on the state pension as their main income, will fall into real trouble. Likewise, further cuts to housing benefit will result in greater homelessness. In 2011, when the government cut housing benefit from 50% of average local rents to 30%, there was a sharp increase in evictions from the private rented sector and in homelessness. A massive cut in public spending in the UK will result in a significant increase in poverty.

### Application of economics in the real world 7.3: How the Conservatives tried to redefine child poverty

- 1 Absolute poverty is a condition characterised by severe deprivation of basic human needs, including food, clean drinking water, sanitation facilities, primary healthcare, shelter and appropriate clothing. Individuals living in absolute poverty are in real danger of becoming seriously ill and dying. In contrast, relative poverty occurs when individuals are poor in relation to the mainstream of their society. In the UK, this has traditionally been measured as a household living off an income that is less than 60% of the median income.
- 2 In 2016 the government moved away from the definition of relative poverty as households living off an income less than 60% of the median income because it argued that it was a deeply flawed measure of child poverty in the UK. The government argued that when the economy shrank in the Great Recession of 2008/09, statistically the number of children living in relative poverty went down. In reality, however, the number of children living in poverty did not change. In 2020, the government introduced a new measure of poverty based on social metrics. The government believes that this will provide a wider measurement framework that covers the depth, persistence and lived experience of poverty in the UK.
- 3 It can be argued that the proposed new definition of child poverty is disagreeable because it harks back to the old Victorian distinction between the deserving and undeserving poor. Back in 2013, when Duncan Smith's proposals were being put forward, the Child Poverty Action Group stated that 'the old right rhetoric of the deserving and undeserving poor has been resuscitated, fed by an increasingly hostile media campaign towards those on benefits'. In 2012, the *New Statesman* reported that the number of times the word 'scrounger' had been used annually in UK newspapers had risen to over 2,500 in 2012 from an average of 250 between 1994 and 2009.
- 4 One of the main causes of homelessness that leads to rough-sleeping is the cost and availability of housing. In 2011, as part of the coalition government's deficit reduction programme, housing benefit was reduced from 50% of average local rents to 30%. This made private rented housing extremely difficult for low-income groups to afford, especially given the short supply of social rented housing. As a consequence of government policy, the main reason for the increase in homelessness between 2010 and 2018 was evictions from the private rented sector. Therefore, if the government were to reverse the policy and increase housing benefit so that rented housing becomes more affordable, rough-sleeping will be reduced. This will require an increase in government spending and will not solve the other causes of homelessness, but it will make a significant difference.

### Application of economics in the real world 7.4: Universal Credit has probably placed more families in the poverty trap

- 1 A 'cliff edge' refers to a situation where a household's income from paid work increases but its entitlement to claim welfare benefits decreases, making the household worse off overall. This is illustrated in Figure 7.11 when a household's net annual earnings increase above £7,400. Prior to this point the household's children receive free school meals, but once the household passes the £7,400 threshold, this benefit is withdrawn, effectively making the household £1,311 worse off.

2 Universal Credit has been rolled out so that all new applicants, or those individuals who apply for change of circumstances, have been moved on to the new benefits system. In reality, the government is still running two different welfare benefit systems, but by 2023 those individuals on ‘legacy benefits’ will be moved onto Universal Credit.

3 A universal benefit is one that every eligible individual and/or household can receive, regardless of income. For example, pensioners in the Greater London Area are entitled to claim a Freedom Pass, which enables them to travel for free on public transport.

A means-tested benefit is only allocated to individuals and/or households that have had their income and/or wealth assessed to check that they are eligible to receive the benefit. For example, Universal Credit is means-tested and individuals who have more than £16,000 in savings are ineligible to claim the benefit.

4 Universal Credit was designed to simplify the welfare benefits system and make it easier for low-income households to claim benefits to which they were entitled. Under the previous system, low-income households could apply for six main welfare payments: income support, income-based jobseeker’s allowance (JSA), income-related employment and support allowance (ESA), housing benefit, child tax credit, and working tax credit. The six different welfare payments required applicants to complete different forms and created a complex system of paperwork and bureaucracy. By rolling the six different benefits into one universal welfare payment, the government hoped to simplify the system and make it easier for low-income households to claim the welfare payments that they are eligible to collect.

Previously, households with children were able to claim free school meals if they received any of the six welfare payments. As a temporary measure, the government has allowed all households in receipt of Universal Credit to claim free school meals. The long-term aim, however, is to introduce a threshold for households earning an income of more than £7,400 and reduce their ability to claim free school meals. The government argues that this will allow the benefits system to target resources at low-income households and that 50,000 more children will become eligible for free school meals; however, by introducing a threshold it will create a poverty trap. The government has said that it will avoid the problem of ‘cliff edges’ and the poverty trap by reducing welfare payments as the earnings of claimants increase. This works in principle, but at present the government has been unable to explain how the system will operate effectively in practice.

## Application of economics in the real world 7.5: Enrolling low-paid workers into workplace pension schemes

- 1 An opt-in pension scheme is when workers have to actively choose to enter the scheme and complete the necessary enrolment forms. Once workers have opted in, pension contributions are deducted from their pay packet on a monthly basis. In contrast, an opt-out system is when a worker is automatically enrolled into the pension scheme when they start a job and the worker has to choose to leave the scheme by completing paperwork requesting to leave.
- 2 According to the UK government, zero-hours contracts, which are also known as casual contracts, cover ‘on call’ work, which means that workers are on call to work when the employer needs them, employers do not have to give employees work, and workers do not have to do work when asked.
- 3 The state pension is the pension that UK workers are entitled to claim in retirement if they have paid National Insurance (NI) contributions through the income taxation system during their working lives. In 2023, a retired worker who has paid all of their NI contributions can draw £203.85 per week in state pension. The state pension is paid by the government and underwritten by the state.

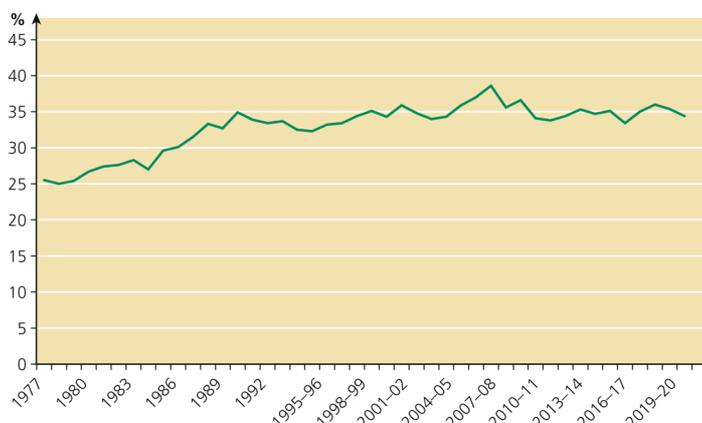
A private pension is when a worker pays into a pension scheme to provide an income in retirement. Many workers have private pensions through their workplace, although there are a number of different types of private pension scheme. Employers will often make contributions to an employee’s pension, but the level of remuneration varies widely. The majority of private pension schemes employ fund managers to invest the workers’ contributions in financial assets, such as equities, property, bonds and cash, over the course of their working life to build up the size of the pension pot.

- 4 According to traditional economic theory, human beings are rational and make self-interested decisions that maximise utility. It is logical to assume that rational workers would therefore opt into workplace pension schemes because their employers will pay monthly contributions that will help workers save for an income in retirement. In practice, however, a large number of workers do not opt into pension schemes, not because they oppose them but due to their busy lives, limited time, lethargy and inertia. Evidence from behavioural economics shows that the majority of workers are happy to be enrolled into a pension scheme but simply never get around to completing the paperwork. This results in workers failing to make provision for retirement and often finding that they have insufficient savings and are confronted with poverty and lower living standards in later life.

To correct the market failure, behavioural economists advocate changing the pension system to ‘nudge’ workers into making the correct decision. Rather than opting into the pension scheme, workers would be automatically enrolled and would have to opt out if they do not want to participate. If workers feel strongly about opting out, they will complete the necessary paperwork, but the design of the auto-enrolment system means that the majority of workers would not have to take action and would be ‘nudged into making the right decision’ that increases savings for retirement and prevents a possible market failure.

## End-of-chapter questions

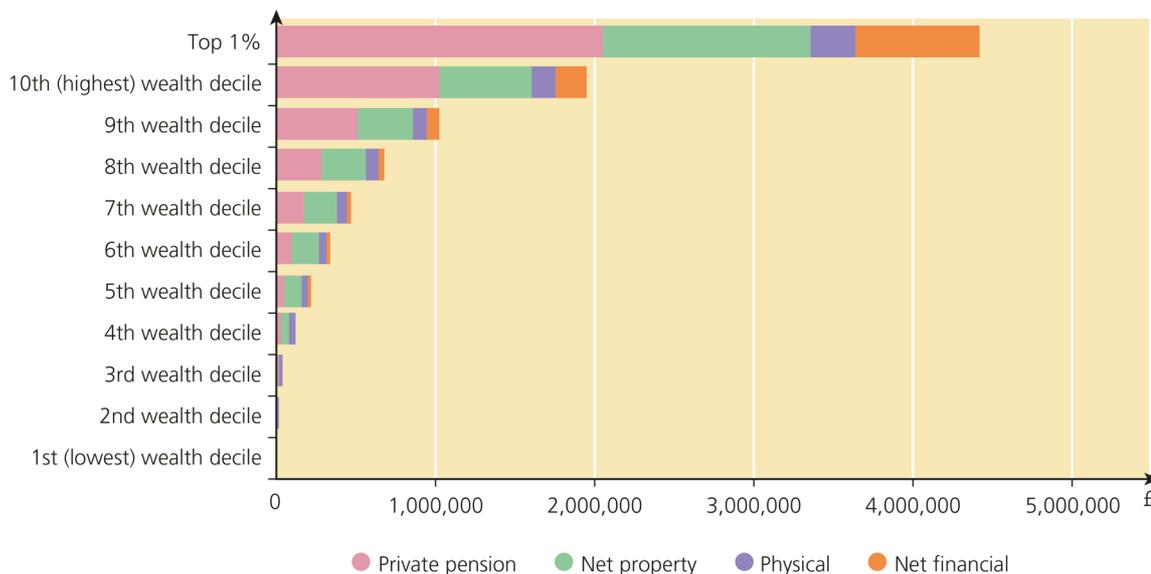
- 1 The Gini coefficient measures the extent to which the distribution of income among individuals or households within an economy deviates from a perfectly equal distribution. The lower the Gini coefficient, the more equally income is distributed. Figure A7.1 shows changes in the Gini coefficient for income for the UK between 1977 and 2021. The graph shows the income coefficient rising from a low value of approximately 0.255 in 1977 to a peak of around 0.38 in 2007/08. It then fell slightly for most of the rest of the data period, remaining at around 0.35. Over the whole period, income became less equally distributed, though there were variations from year to year.



Source: ONS

**Figure A7.1** UK Gini coefficient for equivalised disposable income, 1977–2021

Figure A7.2 shows inequalities in the distribution of wealth.



Source: ONS, *Wealth and Assets Survey*

**Figure A7.2** Median household wealth by decile (£m)

The Institute for Public Policy Research argues that the gap between the richest 1% and the rest of the country in ownership of wealth is continuing to rise, worsened before 2018 by weak wage growth and rising living costs. The growth in property values in recent years might have helped homeowners, yet the younger generations have suffered. Millennials, or people born after 1981, are four times more likely to be renting, and only half as likely as baby boomers to own their own home by the age of 30.

On some measures, inequality in the UK has declined slightly in the past few years, particularly since the financial crisis reduced the earnings of the highest-income workers following the implosion of the banking system, while the rising minimum wage has also helped.

The Gini coefficient for the distribution of wealth shows that wealth inequality has dropped slightly or remained broadly the same in the past decade, at 0.62.

- Keynesian and free-market economists hold different views about how progressive taxation and transfers affect income inequalities and poverty. Keynesian and other interventionist economists believe that progressive taxation and transfers from the rich to the poor are necessary because they reduce and possibly eliminate a market failure brought about by free-market forces, which left to their own devices bring about too much inequality.

By contrast, free-market economists believe that such intervention results in the unintended consequence of reducing personal incentives, which in turn in the long run reduces economic growth. The poor end up in the long run gaining a larger share of a smaller economic cake. It would be better for them to gain a smaller share of a fast-growing economic cake brought about by free-market forces.

The best way to decide between these two views is to look at the evidence. Between 2010 and 2019 ‘austerity’ policies were implemented by UK governments which reduced transfers to the poor. The aim was to reduce the size of the state and to promote the role of free-market forces. For Keynesians the decade is known as the ‘lost decade’, as arguably recovery from the 2008/09 recession was unnecessarily slowed when slow economic growth was accompanied a rise in poverty.

- The answer to this question covers similar issues to the answer given to question 2.

- 4 Absolute poverty is a condition characterised by severe deprivation of basic human needs, including food, safe drinking water, sanitation facilities, health, shelter and education.

Relative poverty occurs when income is below a specified proportion of average income: for example, below 60% of median income.

- 5 If we slightly ‘tweak’ the answer we have given to question 2, we arrive at our answer to this question. The view that faster economic growth is needed to reduce poverty and that this requires a less equal distribution of income is very much a pro-free-market view. According to this view, inequality is the price of economic growth, and when the better-off in society flourish, those at the bottom also benefit from the so-called trickle-down effect.

Trickle-down economics claims that tax cuts for the wealthy trickle down to everyone else as a result of the wealthy spending their extra money. However, there is little empirical support for this view. Instead the rich gain most from the tax cuts and the poor gain little — and indeed suffer a fall in income if the tax cuts for the rich are accompanied by public spending cuts aimed in their direction.

In recent years in the UK, tax cuts for the rich have arguably produced neither faster economic growth nor benefits for the poor. The words in the question ‘necessarily requires’ are questionable.

## Test yourself answers

### TEST YOURSELF 7.1

The correct answer is (b), (d) and (f).

### TEST YOURSELF 7.2

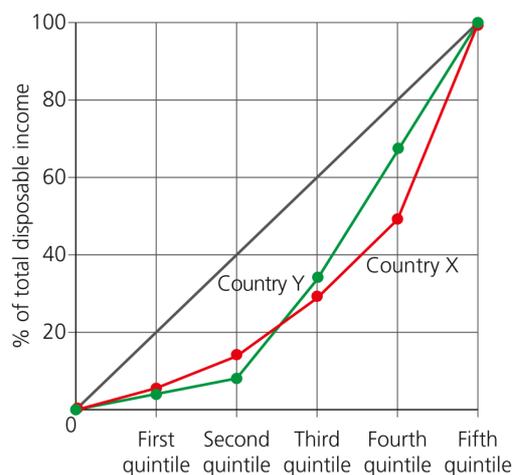
When a set of data is divided into ten equal parts, each of them is called a decile.

### TEST YOURSELF 7.3

Statements B and D are normative statements incorporating value judgements. The other statements are positive statements which can be tested to see if they are incorrect. If a positive statement does not pass the test, it is falsified. A positive statement does not have to be true. The key point is that positive statements can in principle be tested and possibly falsified, while normative statements cannot.

### TEST YOURSELF 7.4

The Lorenz curves for Countries X and Y calculated from Table 7.2 are shown in the diagram below.



### TEST YOURSELF 7.5

Statements A and D provide the correct answer. Statement A must be correct because a rise in the share of income going to the bottom 50% of income earners means that the share of income going to the top 50% must be falling. A Gini coefficient of zero expresses perfect equality, so statement D must be correct.

### TEST YOURSELF 7.6

The country started off with a highly unequal distribution of income, which over the five-year period became less unequal. However, the distribution of income was still unequal at the end of the five-year period.

### TEST YOURSELF 7.7

Absolute poverty has been defined as a condition characterised by severe deprivation of basic human needs, including food, safe drinking water, sanitation facilities, health, shelter, education and information. This definition encompasses the stem to the question of ‘the inability to satisfy basic food needs’. By contrast, relative poverty is the condition in which people lack the minimum amount of income needed in order to maintain the average standard of living in the society in which they live. Obesity, or the state of being grossly fat or overweight, may, because of bad diet, be a symptom of relative poverty, but less so of absolute poverty. Idleness has been blamed by some as a cause of poverty, though others say it is more often the result of poverty.

### TEST YOURSELF 7.8

A good education may help to enable children and young adults from poor families to escape poverty. However, if a good education is largely available only to those who are well off, those from poor families may still end up relatively poor.

### TEST YOURSELF 7.9

Universal Credit is a means-tested benefit for people of working age who are on a low income. It is replacing six existing means-tested benefits.

### TEST YOURSELF 7.10

Original income is the income received by a household or person before allowing for any payment of income tax and other taxes, and the receipt of various transfer payments such as social security benefits. Disposable income, also known as disposable personal income (DPI), is the amount of money that households have available for spending and saving after income taxes have been paid.

### TEST YOURSELF 7.11

In the case of income tax, the tax threshold is the level of income at which a person starts paying the tax. A tax ceiling is the level of income above which no more tax is paid. In the case of welfare benefits, the benefits ceiling is the level of income above which no further benefit can be claimed.