Essay style question on inequality

(a) Explain why income and wealth are unevenly distributed in the UK [10].

Wealth is a stock of assets owned either by an individual or an economy as a whole. Income is the monetary reward for participation in the production of goods or services over a given time period.

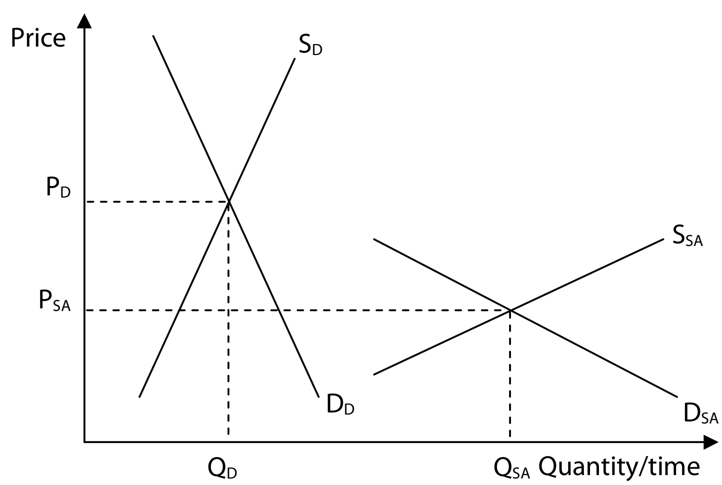
Wealth and income are not evenly distributed in the UK. That is to say there are some individuals with higher incomes than others and/or a greater stock of assets, measured in monetary terms.

Older individuals are more likely to have a greater stock of assets as they can be accumulated over time. Whilst income and wealth are two distinct concepts there is a close link between them. Those with large wealth are likely to gain an income from their assets, and to accumulate wealth a surplus income is required above that necessary for life.

Generally older individuals will also be more skilled and their greater experience will increase the value of their human capital. This means the potential earnings of older workers are generally higher as they are more productive.

Other individuals may obtain wealth through inheritance. This wealth can often be put to use to generate a higher income.

Wages, and so income, are determined by the supply and demand for particular skills as sub-markets of the labour market. For example, supply and demand for doctors is much smaller and more inelastic than that for supermarket assistants. This is due to the high levels of training required for an individual to become a doctor, acting as a barrier to entry for workers considering entering the industry.



This disparity in pay rates of $P_{SA}P_D$ can be seen as a form of market failure as it results in uneven distribution of income.

In a free market the higher wage rate for doctors would cause more workers to move into that industry, but due to occupational immobility workers are unable to easily move.

Geographical immobility also leads to market failure as workers are unable to move to different regions where pay is higher due to home ownership and social ties.

Further inequalities are caused by groups of workers with a lower skills base, or who are participants in very low paid work, particularly women and those from ethnic minorities. Those who live in families with a high dependency ratio, those out of worker who must be supported by those in work, have to spent more of their income so accumulate wealth more slowly and so see their income rise more slowly.

(b) Compare the effectiveness of increasing income tax and increasing transfer payments as ways of reducing income inequality [12].

Increasing income tax will increase total government revenue, ceteris paribus, which the government could use to reduce the effect of income inequalities on an economy.

Increasing transfer payments can reduce incentives to work as workers can gain more from not working and the opportunity cost of working is increased.

Currently the highest rate of income tax is 40% and most households with higher incomes will generally have at least one individual paying this rate of tax.

Through income tax and transfer payments the government currently improves the inequality disparity by a factor of around 2.5. The Gini coefficient is reduced by 30% due to these measures, through indirect taxation worsens the situation as they are regressive taxes, taxing those on a lower income a greater proportion of their income than those on a higher income.

There are a variety of forms of transfer payment made to different individuals in society in an aim to reduce inequalities.

Means tested benefits are targeted at only those who require them so are theoretically very effective at redistributing income. Potentially means tested benefits can become complicated to administer and many who may be eligible for the benefit put off by the large amounts of paperwork required. An inefficient and expensive benefits system is also undesirable as this means the total payment would be reduces, or there would be an opportunity cost elsewhere.

Potentially with any benefit system the reduced incentive to work may mean people choose not to work, instead becoming reliant upon benefits, which is not beneficial to the government's long term plan of reducing the income inequality.

Therefore benefits such as the working family's tax credit are given by the government on a means tested basis to families on low income to reduce the pressures of tax.

Universal benefits are much cheaper to administrate but expensive to pay out as all are entitled to them. This can act as an incentive as workers on low pay do not loose the benefit as their pay increases but this effect is more likely to be outweighed by the lowered incentive to work.

Many economists may argue that benefits do not help in the long run and that the short run reductions in incentives to work will cause problems in the long run. Instead workers on low income or out of work should be given opportunities such as the 'new deal' and training opportunities to improve their occupational mobility and allow the free market to function more effectively and for workers to more easily enter the markets for higher paid jobs.

Progressive taxation through income tax, where the rate paid increases as income increases, and the use of benefit systems can be very effective at improving equality.